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1040 Income Tax Preparation

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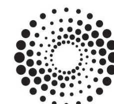

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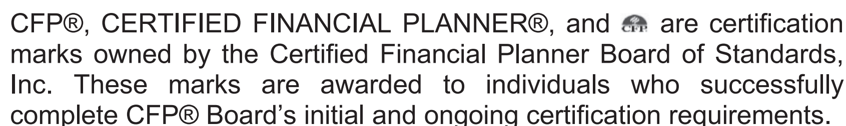

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INTRODUCTION

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1040 Income Tax Preparation (DT1TG11)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course covers issues related to filing status, exemptions, income and adjustments, medical expenses, deductible taxes, interest expense, personal credits and tax payments.
PUBLICATION/REVISION DATE:	December 2011
PREREQUISITE/ADVANCE PREPARATION:	None
CPE CREDIT:	10 QAS Hours, 10 Registry Hours
CTEC CREDIT:	10 Federal CTEC Hours, 0 California Hours
	Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
	Enrolled Agents: This CPE course is designed to enhance professional knowledge for Enrolled Agents. Gear Up is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
CFP® CREDIT:	5 CE Hours – CFP® Credit hours are half the number of CPE credit hours
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	**December 31, 2012**
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES

Chapter 1: Filing Status

Completion of this chapter will enable you to:

- Determine the appropriate filing status.

Chapter 2: Personal Exemptions

Completion of this chapter will enable you to:

- Determine allowable personal exemptions.

Chapter 3: Wages and Salaries

Completion of this chapter will enable you to:

- Report wages and other information from Form W-2.

Chapter 4: Interest and Dividend Income

Completion of this chapter will enable you to:

- Determine the tax rate applicable to qualified dividends.
- Explain the tax treatment when bonds are purchased at a premium or a discount, and describe the treatment of interest on government bonds.

Chapter 5: Pension and Retirement Income

Completion of this chapter will enable you to:

- Determine the taxability of social security benefits.
- Apply the rules relating to distributions from traditional and Roth IRAs and describe how to convert a traditional IRA into a Roth IRA.
- Explain how qualified retirement and IRA distributions can be rolled over into another plan and apply the minimum distribution rules.

Chapter 6: Other Items of Income

Completion of this chapter will enable you to:

- Apply the rules covering education savings accounts and health savings accounts.
- Explain the tax treatment of certain other income items, including alimony recapture, tax refunds, unemployment income and other miscellaneous income.

Chapter 7: Adjustments to Income

Completion of this chapter will enable you to:

- Apply the rules relating to contributions to various types of IRAs.
- Identify and determine other adjustments to income, including the self-employed health insurance deduction, health savings accounts, moving expenses and alimony.

Chapter 8: Standard Deduction

Completion of this chapter will enable you to:

- Determine the standard deduction applicable to each filing status.

Chapter 9: Medical Expenses

Completion of this chapter will enable you to:

- Identify deductible medical expenses and apply the limits on the deductibility of long-term care insurance.

Chapter 10: Charitable Contributions

Completion of this chapter will enable you to:

- Identify and substantiate charitable contributions, applying the limitations on the deduction of charitable contributions.

Chapter 11: Deductible Taxes

Completion of this chapter will enable you to:

- Apply the rules relating to deductible state income or sales taxes, real estate taxes and personal property taxes.

Chapter 12: Interest Expense

Completion of this chapter will enable you to:

- Identify the proper classification of interest expense and calculate the allowable deduction for various categories.

Chapter 13: Other Itemized Deductions

Completion of this chapter will enable you to:

- Identify other allowable itemized deductions and apply limits as required.

Chapter 14: Personal Credits

Completion of this chapter will enable you to:

- Determine eligibility and deductibility of various personal credits available to individuals.

Chapter 15: Tax Payments

Completion of this chapter will enable you to:

- Identify when the penalty for underpayment of estimated tax applies and evaluate alternative tax payment options.

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- PPC and AuditWatch Conference on Technology Solutions for Increased Audit Efficiency | Las Vegas, October 25
- PPC and AuditWatch Conference on Audit Quality and Efficiency | Las Vegas, October 26–27
- PPC and AuditWatch Conference on Key Accounting and Auditing Developments | Las Vegas, October 28

AuditWatch Live Seminars
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Chapter 1: Filing Status

Learning Objective

Completion of this chapter will enable you to:

- Determine the appropriate filing status.

Introduction

A taxpayer's filing status establishes a single taxable unit for determining federal income tax for the tax year. Filing status affects income, deductions, and credits reportable or available to the taxable unit.

There are five filing status possibilities for individuals:

1. Single
2. Married filing jointly (MFJ)
3. Married filing separately (MFS)
4. Head of household (HOH)
5. Qualifying widow(er) (QW) with dependent child

A taxpayer's marital status is determined as of the last day of the tax year. Thus, a taxpayer who marries on December 31 is deemed married for the entire tax year.

Filing Single and Married Filing Jointly

Single

A taxpayer is single if unmarried or separated from a spouse, either by divorce or a separate maintenance decree, on December 31. A widow(er) whose spouse died before 2010 is single unless he or she meets the tests for qualifying widow(er).

Married Filing Jointly

Taxpayers may file jointly if on the last day of the year they are:

- Married and living together,
- Married and living apart, but not legally separated or divorced,
- Separated under an interlocutory (not final) divorce decree, or
- Living in a common-law marriage, if common-law marriage is recognized in the state where they currently reside or in the state where the marriage began.

As discussed later, if one spouse died during the year, the survivor can file jointly if the couple met one of the above tests on the date of death and the survivor did not remarry during the year.

Same-sex couples cannot file joint returns. Only married couples can file jointly. Same-sex couples cannot be considered married for federal tax purposes even if state law sanctions such marriages. The Defense of Marriage Act provides that the word “marriage” means only a legal union between one man and one woman as husband and wife.

Filing Status in Year of Spouse’s Death

In the year of a spouse’s death, the survivor and deceased spouse generally are considered married for the entire year for tax purposes. Therefore, the survivor can file a joint return with the deceased spouse. This rule also applies if both spouses die during the same tax year. However, if the surviving spouse remarries before year-end, “married filing separately” status must be used for the decedent’s final return.

Example: Qualifying to file a joint return.

Jim’s wife, Pat, died in February 2011. Jim did not remarry before the end of the year. Jim, as a surviving spouse, can file a joint return with Pat for 2011.

However, if Jim remarries before year-end, a joint return for 2011 cannot be filed with Pat. (However, Jim can file a joint return with his new spouse.) In this case, Pat’s filing status is married filing separately for her 2011 (final) return.

Generally, a joint return can be made only with the cooperation of the executor/executrix or administrator of the decedent’s estate. However, a surviving spouse, acting alone, can file a joint return with the deceased spouse under the following conditions:

1. The decedent did not file a tax return (as married filing separately) for that year (which includes the year of death or the preceding year if the decedent died after the close of the preceding tax year and before the due date for filing that return).

2. No executor or administrator has been appointed at or before the filing of the joint return or before the last day prescribed by law for filing the return of the surviving spouse (including extensions).

Filing as a Qualified Widow or Widower

The benefits of the married filing jointly tax rates are extended for a qualified widow or widower for the two tax years following the tax year of the death of the spouse. In general, the surviving spouse must be unmarried and pay more than half the cost of maintaining a home that is the principal home for the entire year of a child of the surviving spouse (including step-children) who qualifies for a dependency exemption (without regard to the dependent child’s level of income and without regard to the marital or filing status of the child) on the surviving spouse’s return. Also, the taxpayer must have been eligible to file a joint return with the spouse in the tax year of the spouse’s death.

Tax Effects of Using Married Filing Separate Status

Married taxpayers have the option of filing joint or separate returns unless (1) either spouse is a nonresident alien at any time during the year (unless the nonresident spouse elects to be treated as a resident alien, which causes the nonresident spouse's worldwide income to be subject to U.S. tax); or (2) they have different tax year-ends (unless the different years are due solely to death). If either of these exceptions applies, married filing separate returns are required.

Taxpayers who are legally separated at year-end under a decree of divorce or separate maintenance are considered unmarried for that tax year. They must file as single taxpayers (or head of household or another filing status for which they qualify).

Married taxpayers generally achieve the best tax results by filing a joint return. However, tax savings may result from filing separate returns (e.g., when either spouse has miscellaneous itemized deductions deductible to the extent they exceed 2% of AGI, or medical expenses exceeding 7.5% of AGI). By filing separately, the AGI for each spouse is usually reduced, thereby reducing the AGI limitation floor for each spouse. If one spouse can report a disproportionate amount of expenses from these categories, the lower AGI floor may allow a larger amount of the expenses to be deducted on the tax return of that spouse. However, in community property states, income and expenses generally must be split equally unless they are attributable to separate funds.

Changing Filing Status after Return Is Filed

If separate returns are originally filed, the spouses generally can elect to file an amended joint return (i.e., Form 1040X) within three years of the original due date (excluding extensions) of the separate returns. However, a change from joint to separate returns is more restrictive. If a joint return is originally filed, separate returns replacing it must generally be filed by their due date.

Implications of Joint and Separate Filing Status for Married Taxpayers

For married taxpayers the implications of filing a joint return or filing separate returns extend beyond the tax rates and standard deduction amounts.

Reasons to file separately include the following:

- **No joint liability.** Each spouse who signs a joint return is responsible for the accuracy of the return as well as the payment of the tax. A spouse who files separately is not responsible for reporting or paying tax on items attributable to the other spouse.

- **Some couples pay less tax filing separately.** Tax brackets and standard deduction for MFS are exactly one-half of those for MFJ. Spouses with equal incomes will generally owe the same tax under either filing status unless one spouse has medical expenses, casualty losses or employee business expenses subject to a percentage limitation based on AGI. A couple in this situation may pay less tax by filing separately because these expenses are limited by the AGI of only one spouse. If one spouse has significantly higher income than the other, the couple will generally pay less tax filing jointly.

Some disadvantages of married filing separately are shown in the following table:

Lost Credits	• Earned income credit. • Credit for the elderly or the disabled unless spouses lived apart for the entire year. • Child care credit unless spouses lived apart for last six months of the year. • Adoption credit unless spouses lived apart for last six months of the year.
Lost Education Benefits	• Hope (American Opportunity Tax Credit for 2009 and 2010) and lifetime learning credits. • Student loan interest deduction. • Tuition and fees deduction. • Savings bond interest exclusion.
Standard Deduction	• If one spouse itemizes deductions, the other must also itemize (that is, cannot claim the standard deduction).
Taxable Social Security	• A greater percentage of social security benefits may be taxable unless the spouses lived apart for the entire year.
IRAs	• Traditional IRA deduction and Roth IRA contributions phased out at $10,000 of modified AGI unless the spouses lived apart for the entire year. • No conversions to Roth IRA. • Spousal IRA rules do not apply.
Capital Losses	• Net capital loss deduction is limited to $1,500 per spouse.
Sale of Home	• Exclusion of gain is limited to $250,000 per spouse.
Passive Losses	• Rental real estate loss allowance is limited to $12,500 per spouse, with lower phase-out thresholds. • One spouse's passive loss cannot be offset by the other spouse's passive income.
AMT Exemption	• In addition to the exemption phasing out, some high income taxpayers must add an amount back to AMTI.

Deciding on Filing Status in Community Property States

State law governs whether there is community property and income; therefore, the property laws for the specific state in question should be reviewed. The nine community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Community property is generally all property acquired by either spouse during marriage that is not considered separate property. Separate property includes property owned before the marriage and property acquired by a spouse after marriage by gift, devise, bequest or inheritance, or by purchase using separate property funds.

Generally, community income is all income from community property and wages and other pay for services earned by either spouse during their marriage. In some community property states, income from separate property is also community income. Other community property states follow a different rule, whereby income from separate property is considered the separate income of the spouse who owns the property. Deductions on married filing separately (MFS) tax returns depend on whether the expenses were paid out of community or separate funds. If the deductions were paid out of community funds, they must be split equally for income tax purposes. Deductible expenses paid from separate property funds of one spouse generally are deductible by that particular spouse.

Even if taxpayers live in a community property state, a premature IRA distribution (and the related early withdrawal penalty) is not reportable by the nonowner spouse when separate returns are filed (*Morris*).

Practitioners should first calculate what the tax would be if a joint return is filed, since the community property laws do not affect joint returns. Preparers should then calculate the tax on separate returns using the community property laws of the state. For income tax purposes, community property rules generally require an equal allocation of income earned by spouses regardless of who actually earned it. But, for self-employment (SE) tax purposes, the IRS maintains that the spouse conducting a trade or business is solely liable for SE tax on 100% of the community trade or business net income. Since the benefits of using MFS status generally result from unequal incomes or deductions, community property rules frequently will negate these benefits.

Where a husband and wife are the sole owners of an unincorporated trade or business entity that is owned by them as community property, the IRS will accept the treatment of the entity by the spouses as either a disregarded entity (sole proprietorship) or a partnership for federal tax purposes. If treated as a partnership, each spouse would report their respective share of the SE income instead of it being reported 100% by the spouse conducting the business as previously mentioned. For years beginning after 2006, a husband and wife in this situation can ensure disregarded entity (sole proprietorship) treatment provided they both materially participate [under the Section 469(h) passive loss rules] in the business and make an affirmative election to be so treated under IRC Sec. 761(f)(2), as added by the Small Business and Work Opportunity Tax Act of 2007.

Eligibility for Head of Household Status

Failure to use head of household (HOH) filing status is one of the most common tax preparation errors cited by the IRS. HOH status is preferable to single or MFS status because tax rates are lower and the standard deduction is larger.

Requirements for Head of Household Status

Head of Household

To qualify as head of household (HOH) the taxpayer must meet all of these tests.

1. The taxpayer is not married (or considered unmarried) at the end of the year.
2. The taxpayer paid more than half the cost of keeping up his or her home.

3. The home was the principal residence for more than half the year of either:

   a. The taxpayer's qualifying child (defined later) or

   b. The taxpayer's qualifying relative (defined later) who is the taxpayer's dependent. However, for HOH purposes, two types of qualifying relatives don't count: (1) a person who is a qualifying relative only because he or she was a member of the taxpayer's household the entire year and (2) a person who is a qualifying relative only because of a multiple support agreement.

4. The taxpayer is a U.S. citizen or resident during the entire year.

Special Rules. Certain special rules apply:

- **Temporary absences.** A taxpayer and his or her qualifying person are considered to live together even if one or both of them are temporarily absent from the home due to special circumstances such as illness, education, business, vacation or military service. It must be reasonable to assume that the absent person will return to the home after the temporary absence. The taxpayer must continue to keep up the home during the absence.

- **Married child.** A taxpayer's married child can qualify him or her for HOH filing if the child is an otherwise qualifying child, does not file a joint return (unless filed only to claim a tax refund and neither spouse would have a tax liability if they filed separate returns) and is a U.S. citizen or resident, or a resident of Canada or Mexico.

- **Divorced parents.** Even though a custodial parent has released the right to claim the exemption to the noncustodial parent, the custodial parent may still file as HOH.

Example: Divorced parents.

Andrew and his former spouse, Jan, have a 14-year-old daughter, Alyson. Alyson lived with her mother for eight months and with her father for four months of the year (Jan is the custodial parent). Alyson is a dependent of Jan because she is her qualifying child. In 2011, Jan released the right to claim Alyson as a dependent to Andrew, the noncustodial parent. However, since Jan still maintained her home and Alyson lived with her for more than half the year, Alyson is Jan's qualifying person for HOH purposes. Andrew, on the other hand, cannot claim HOH filing status based on Alyson.

- **Parent not living with taxpayer.** A parent does not need to live in the taxpayer's home for the taxpayer to qualify as HOH. A taxpayer can qualify by paying more than half the cost of keeping up the parent's home. The home must be the parent's main home for the entire year. A taxpayer who pays more than half the cost for keeping a parent in a rest home or nursing facility is keeping up a main home. The parent must be the taxpayer's dependent (but not under a multiple support agreement) for HOH status to apply.

- **Considered unmarried.** A married taxpayer can file as HOH if all of the following tests are met.

  1. The taxpayer files a separate return.

  2. The taxpayer paid more than half the cost of keeping up his or her home for the tax year.

  3. A spouse did not live in the home during the last six months of the tax year.

  4. The taxpayer's home was the main home for more than half the year of his or her child or step-child, adopted or foster child. The child must be a dependent unless the child's noncustodial parent is allowed the exemption under a decree, agreement or release of exemption.

Caution: Tax Court denied HOH status to a taxpayer whose spouse would not move out and therefore slept in her home at some time during the last six months of the year (Hopkins).

- **Cost of keeping up a home.** Costs include property tax, mortgage interest, rent, utilities, repairs, property insurance, food consumed on the premises and other household expenses.

- **Birth or death.** A qualifying person who is born or dies during the year is not required to have lived in the taxpayer's home for more than half the year. Instead, the requirement is met if the taxpayer provides more than half of the cost of keeping up that person's home for the period during which the individual lived.

Chapter 1 Exercises

Question 1: Parent with separate residence.

Paul is single and provides more than half the support for his elderly mother, whose only income is social security. His mother lives in her own apartment, but Paul pays the rent, utilities, etc. Can Paul file as head of household (HOH)? Why or why not?

Question 2: Marital status at the tax year-end.

Part 1: Heather's daughter (who is her dependent) lives with her more than half the year. Heather and her husband have lived separately since May of 2011 and she has paid (from separate funds) the utilities and rent on her condo since they separated. Heather and her husband will file separate tax returns for 2011. Heather wants to file as head of household for the 2011 tax year but does not know whether she is considered unmarried for this purpose. Assume she meets all other requirements to qualify for head of household.

Part 2: What are some of the benefits of filing as HOH?

Question 3: Head of household status.

Ringo and his former spouse Maureen have a 14-year-old son, Zak. Zak lived with his father for eight months of the year and with his mother for the balance of the year. Ringo is the custodial parent, but for 2011 he released his right to claim Zak as a dependent to Maureen, the noncustodial parent. Can Ringo file as head of household? Can Maureen file as head of household? Explain why or why not in each case.

Chapter 1 Exercise Solutions

Question 1: Parent with separate residence.

Paul is single and provides more than half the support for his elderly mother, whose only income is social security. His mother lives in her own apartment, but Paul pays the rent, utilities, etc. Can Paul file as head of household (HOH)? Why or why not?

Answer: *Since Paul's mother meets the definition of a qualifying relative, he can claim a dependency exemption for her because she is his parent and he pays more than half the cost of maintaining her home for the entire year. Paul can use head of household filing status, even though his mother does not live in the same household.*

Taxpayers may claim head of household status if they maintain a household that is the principal place of abode for their parents (mother, father, or both parents) if the parent or parents qualify as a dependent [IRC Sec. 2(b)(1)(B)]. Unlike the requirements for a qualifying child who must live with the taxpayer, the taxpayer can maintain separate living quarters for his or her parents. If a parent requires additional care such as provided by assisted living situations or nursing homes, a single room or private quarters in which the taxpayer's parents live can qualify as a household (Rev. Rul. 70-279).

Note that qualifying persons other than parents must live in the same household with the taxpayer to qualify the taxpayer for head of household status [IRC Sec. 2(b)(1)(A)].

Question 2: Marital status at the tax year-end.

Part 1: Heather's daughter (who is her dependent) lives with her more than half the year. Heather and her husband have lived separately since May of 2011 and she has paid (from separate funds) the utilities and rent on her condo since they separated. Heather and her husband will file separate tax returns for 2011. Heather wants to file as head of household for the 2011 tax year but does not know whether she is considered unmarried for this purpose. Assume she meets all other requirements to qualify for head of household.

Answer: *Under the so-called "abandoned spouse" rules, Heather is considered unmarried for the purposes of HOH status because she meets all four requirements: separate returns are filed; her home was her dependent daughter's home for more than half the year; she paid more than half the cost of maintaining her home; and she and her spouse did not live together during the last six months of the year.*

Part 2: What are some of the benefits of filing as HOH?

Answer: *HOH status is preferable to single or married filing separately (MFS) status because tax rates are lower and the standard deduction is larger. Although we have not yet covered these in this course, filing as HOH rather than MFS provides an abandoned spouse with the following additional benefits, if they apply: (1) claiming credits for child care, earned income, education, and adoption; (2) excluding interest income from Series EE bonds used for higher education; (3) deducting interest on a qualified education loan; (4) converting a traditional IRA to a Roth IRA; (5) claiming the standard deduction even if his or her spouse itemizes deductions; and (6) higher phase-out thresholds for various tax deductions and credits.*

Question 3: Head of household status.

Ringo and his former spouse Maureen have a 14-year-old son, Zak. Zak lived with his father for eight months of the year and with his mother for the balance of the year. Ringo is the custodial parent, but for 2011 he released his right to claim Zak as a dependent to Maureen, the noncustodial parent. Can Ringo file as head of household? Can Maureen file as head of household? Explain why or why not in each case.

Answer: *Ringo can file as head of household even though he is not claiming a dependent exemption for Zak. He is still his "qualifying child" since Ringo maintained his home within which he resided for more than one-half of the year. As such, he can still file as head of household.*

Maureen cannot file as head of household because only one individual can use that filing status if there is one qualifying child. However, if Ringo and Maureen had two children and shared joint custody of both, it appears both parents could claim HOH status as long as they each met the requirement to maintain a household that is the principal place of abode of one qualifying child. This requires that one child live with one parent more than half the year and the other child live with the other parent more than half the year, and that each parent provide more than half the cost of maintaining the household in which each child lives.

Note that claiming HOH status depends on which parent the child resides with for more than half the year along with whether that parent meets the remaining head of household tests. It does not matter which parent claims the dependency exemptions or which parent is awarded custody by the court. Therefore, the ability to claim HOH status for a child often centers on the amount of time spent with each parent. Maintaining records of the amount of time a child spends in each household is critical in joint custody situations.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Sarah's husband died in May of 2011 and she did not remarry. Sarah's filing status for 2011 is:

   a. Married filing jointly or married filing separately.

   b. Qualifying widow or widower.

   c. Single unless she meets the definition of "Head of Household," since she is unmarried as of December 31.

2. The marriage penalty results in which of the following?

   a. Couples with two incomes have the same tax brackets as single individuals.

   b. Couples with two incomes may pay more tax by filing jointly than if they had filed as two individuals.

   c. The marriage penalty was eliminated with the increase in the 10% and 15% brackets to double the size of the bracket for single taxpayers.

3. Mary was married until her divorce in June of the current year and provides a household for her qualifying dependent child. Her choices for filing status include:

   a. Head of household.

   b. Married filing joint as long as her ex-husband will agree.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

1. Sarah's husband died in May of 2011 and she did not remarry. Sarah's filing status for 2011 is: **(Page 2)**

   a. Married filing jointly or married filing separately. [This answer is correct. As long as the surviving spouse has not remarried, she may file a joint return in the year of her husband's death.]

   b. Qualifying widow or widower. [This answer is incorrect. In the year of the spouse's death, the surviving spouse files either a joint return or married filing separately.]

   c. Single unless she meets the definition of "Head of Household," since she is unmarried as of December 31. [This answer is incorrect. In the year of the spouse's death she qualifies to file as married.]

2. The marriage penalty results in which of the following? **(Page 3)**

   a. Couples with two incomes have the same tax brackets as single individuals. [This answer is incorrect. The tax brackets are larger for couples with two incomes than for single individuals.]

   b. Couples with two incomes may pay more tax by filing jointly than if they had filed as two individuals. [This answer is correct. If one spouse has expenses subject to percentage limitation based on AGI, such as medical expenses, they may pay less tax by filing separately, because the expenses are limited by the AGI of only one spouse.]

   c. The marriage penalty was eliminated with the increase in the 10% and 15% brackets to double the size of the bracket for single taxpayers. [This answer is incorrect. The higher rate brackets are not double the single amount and the floor for social security is not double the single amount.]

3. Mary was married until her divorce in June of the current year and provides a household for her qualifying dependent child. Her choices for filing status include: **(Pages 5,6)**

   a. Head of household. [This answer is correct. Mary may file head of household as long as she was unmarried as of December 31 and provided more than half of the cost of keeping up her home for her qualifying child.]

   b. Married filing joint as long as her ex-husband will agree. [This answer is incorrect. Only married couples as of December 31 and certain surviving spouses may elect to file jointly.]

EXAMINATION FOR CPE CREDIT

Chapter 1

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

1. Available filing statuses for individuals include:

   a. Single, Married or Widowed.

   b. Single, Head of Household, Married Filing Jointly, Married Filing Separately or Qualifying Widow/Widower.

   c. Single, Head of Household, Married Filing Jointly, Married Filing Separately, Surviving Spouse or Qualifying Widow/Widower.

   d. Do not select this answer choice.

2. Which of the following is **not** true in regards to the filing status as married?

   a. Taxpayers who are divorced during the year may file as married filing joint if they have not remarried prior to year end.

   b. Certain married taxpayers may qualify for head of household status.

   c. Married taxpayers usually benefit from filing joint but occasionally will save by filing separately.

   d. Filing a joint return can leave each spouse liable for the accuracy of the return and the payment of tax.

3. Mark is single and provides more than half of the support for his elderly mother whose only income is nontaxable social security. His mother lives in her own apartment but Mark pays the rent, utilities, food and basic living costs. What is Mark's filing status and number of exemptions?

   a. Single with two exemptions.

   b. Single with one exemption.

   c. Head of household with two exemptions.

   d. Head of household with one exemption.

Chapter 2: Personal Exemptions

Learning Objective

Completion of this chapter will enable you to:

- Determine allowable personal exemptions.

Introduction

Taxpayers can claim personal exemptions on their tax returns for themselves, their spouses, and dependents under IRC Sec. 151. Certain tests must be met to claim a person as a dependent. Exemption amounts are adjusted annually for inflation; the exemption amount for 2011 is $3,700.

Personal exemptions are phased out for taxpayers whose adjusted gross income exceeds certain inflation–indexed threshold amounts.

The phase-out limits do not apply for 2010, 2011, or 2012. The limitations on personal exemptions will re-surface in 2013 unless further legislation is passed to address the issue.

Dependency Tests and Claiming a Personal Exemption

General Rules for Dependent Status and Claiming a Personal Exemption

A dependency exemption deduction is available for each person who is a dependent of the taxpayer for the year. A dependent is defined as either a qualifying child or a qualifying relative.

Special Rules and Key Terms. There are some special rules that apply throughout the provisions for what constitutes a dependent (i.e., these rules apply to both a qualifying child or a qualifying relative): (1) a dependent of another person cannot claim a dependent on their own return, (2) an individual that files a joint return with his or her spouse in a tax year cannot be a dependent of another taxpayer in that same year (see later discussion for an exception to this rule), and (3) a dependent must be a U.S. citizen or national, or a resident of the United States, Canada, or Mexico. However, this nationality test will not exclude a legally adopted child who is not a U.S. citizen or resident if the taxpayer is a U.S. citizen or national and the taxpayer's home is the child's principal place of abode. Foreign exchange students generally will not meet this test and thus will not qualify as dependents. But, a charitable contribution deduction may be allowed for amounts spent for their support. There is also a special rule allowing a custodial parent to release the exemption to the noncustodial parent for children of divorced or separated parents.

Warning: An individual who is eligible to be claimed as a dependent on another taxpayer's return cannot claim an exemption for himself. This is true even if the tax benefit of the dependency exemption claimed on the other return is eliminated or reduced by the phase-out rules. However, if the parents of a student-child are eligible to claim the dependency exemption for the child but elect to forego claiming the exemption, the student-child may be eligible to claim certain education credits.

A few key terms used throughout these rules are also important to note:

- **Child.** A child means a son, daughter, stepson, or stepdaughter of the taxpayer, and any foster child placed with the taxpayer by an authorized agency or court. For this purpose, a legally adopted individual and an individual placed for adoption with the taxpayer by an authorized agency but not legally adopted by the end of the tax year will be treated as a child of the taxpayer. The child must be younger than the taxpayer unless the child is permanently and totally disabled.

  Note: When an exemption is claimed for a child placed with the taxpayer for adoption, the taxpayer must attach to his return a statement stating the child's name, the name and address of the authorized placement agency, and the date the formal application was filed with the agency.

- **Student.** A student is defined as an individual who is attending an educational institution as a full-time student for some part of each of five calendar months during the year. The IRS has privately ruled that full-time student status includes any part of a month that the individual is registered in school for the number of hours considered to be full-time attendance, regardless of whether classes are actually attended in that month.

- **Brother or Sister.** A brother or sister for purposes of the definition of a dependent includes a brother or sister by half blood.

Social Security Numbers Required for Dependents. The social security number of each dependent claimed must be listed on the tax return, regardless of when the dependent was born. This requirement has been strictly enforced by the courts, despite religious objections (*John Miller; Davis*) and constitutional objections (*Burns*). If the SSN is not shown on the return, the exemption will be disallowed. Parents adopting a child and eligible to claim an exemption for such child can obtain a temporary identification number (adoption taxpayer identification number or ATIN) if they are unable to obtain the child's SSN before the parents file their tax return. An ATIN is obtained by filing Form W-7A (Application for Taxpayer Identification Number for Pending U.S. Adoptions) with the IRS. For individuals claimed as dependents and who are unable to obtain a SSN (e.g., aliens), an IRS ITIN must be obtained and reported on the tax return to claim the exemption. An ITIN is obtained by filing Form W-7 (Application for IRS Individual Taxpayer Identification Number) with the IRS.

Qualifying Child

A *qualifying child* is one who meets the following five tests:

1. Relationship,
2. Age,
3. Residency,
4. Support, and
5. Tie-breaker test for qualifying child of more than one person.

Relationship Test. The child must be the taxpayer's:

- Son, daughter, stepchild, eligible foster child or a descendant of any of them (for example, grandchild), or
- Brother, sister, half-brother, half-sister, stepbrother, stepsister or a descendant of any of them (for example, niece or nephew).

Adopted Child. An individual legally adopted by the taxpayer or an individual lawfully placed with the taxpayer for legal adoption is treated as a child by blood.

Eligible Foster Child. An eligible foster child is one placed with the taxpayer by an authorized placement agency or by judgment, decree or other order of any court of competent jurisdiction and is treated as the taxpayer's child.

Age Test. The child:

- Must be either:
  - Under age 19 at the end of the year, or
  - Under age 24 at the end of the year and a full-time student. A full-time student is one who is enrolled full-time in school (but not online or correspondence schools) during some part of any five months of the calendar year or is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agency. In Letter Rul. 9838027, the IRS allowed the taxpayer to count the month of August when a student registered on August 28 but did not start classes until September 2.
- Can be any age if totally and permanently disabled.

Caution: The age test differs slightly when determining if a child is a qualifying child for the dependent care credit (must be under age 13 if not disabled) and the child tax credit (must be under age 17).

Residency Test. The child must have the same principal residence as the taxpayer for more than half of the tax year. Temporary absences due to special circumstances, including absences due to illness, education, business, vacation or military service, are ignored.

Support Test. The child cannot provide over half of his or her own support. A full-time student does not take into account taxable or nontaxable scholarship payments received in calculating the support test.

Example: Support test.

Russell is age 18 and lives with his mother, Sally. He receives one third of his support from Sally, one third from his uncle Bob and provides one third of his own support. The support test is met since Russell did not provide more than half of his own support.

For the earned income credit, the support test does not apply when determining if a child is a qualifying child.

Tie-breaker Rules—Qualifying Child of more than one Person. It's possible that a child is the qualifying child of more than one person. If that occurs, the taxpayers can decide between themselves who will claim the qualifying child as a dependent. If they cannot agree and more than one person files a return claiming the same child, the tie-breaker rules apply to determine which taxpayer the IRS will allow to claim the child. The tie-breaker rules are summarized in the following table.

Qualifying Child—Tie-breaker Rules	
IF more than one person files a return claiming the same qualifying child and …	**THEN, the child is treated as the qualifying child of the…**
only one of them is the child's parent,	parent.
two of them are the child's parents and they do not file a joint return,	parent with whom the child lived the greater portion of the year.
same as above but the child lived with each parent for the same amount of time during the year,	parent with the highest adjusted gross income (AGI).
none of them is the child's parent,	person with the highest AGI.

Example: Tie-breaker.

25-year-old Shannon and her 3-year-old son, Drake, live with Shannon's mother, Alice, all year. Shannon earns $12,000 for the year. Drake is a qualifying child of both Shannon and Alice because he meets all of the tests with respect to each.

Options for claiming Drake as a dependent:

- Shannon claims Drake.
- Shannon agrees to let Alice claim Drake.

Shannon and Alice cannot agree who will claim Drake so they both claim him on their returns. Under the tie-breaker rules, Shannon has higher priority because she is Drake's parent. The IRS will disallow Alice's claiming Drake as a dependent.

Qualifying Relative

Individuals who do not meet the tests for being a qualifying child of the taxpayer may still qualify as a dependent of the taxpayer as a *qualifying relative*. A *qualifying relative* is a person who is not a qualifying child of anyone else and who also meets the following three tests with respect to the taxpayer:

1. Member of household or relationship,
2. Gross income, and
3. Support.

Unlike a qualifying child, a qualifying relative can be any age.

Member of Household or Relationship Test. The person must:

1. Live in the taxpayer's household for the entire year or

2. Be related to the taxpayer in any of the following ways:
    - Child, stepchild, eligible foster child, grandchild or great grandchild
    - Brother, sister, half-brother, half-sister, stepbrother or stepsister
    - Father, mother, grandparent or other direct ancestor (but not foster parent)
    - Stepfather or stepmother
    - Niece or nephew
    - Aunt or uncle
    - Brother-in-law, sister-in-law, father-in-law, mother-in-law, son-in-law or daughter-in-law

Related persons do not need to be members of the taxpayer's household. Also, relationships established by marriage are not ended by death or divorce.

A person who died during the year and was a member of the household until death meets the member of household test. A child who was born and died during the year meets the member of household test. A person does not meet the member of household test if at any time during the tax year the taxpayer's relationship with the person is in violation of local law.

Gross Income Test. The person must have less than $3,700 of gross income in 2011. Gross income includes:

- All taxable income in the form of money, property or services.
- Gross receipts from rental property (do not reduce for taxes, repairs and other deductions).
- For a Schedule C business, net sales minus cost of goods sold plus miscellaneous business income.
- A partner's share of the gross (not net) partnership income.
- Unemployment compensation and taxable scholarships and fellowship grants.

Gross income does not include:

- Tax-exempt income (certain social security benefits, municipal bond interest, some scholarship benefits, etc.).
- Income earned by a totally and permanently disabled person at a sheltered workshop operated by a tax-exempt organization or government agency that provides special instruction to alleviate the disability. To be excluded, the income must be incidental to medical care and must come solely from activities at the workshop.

Support test. The support test is met if:

1. The taxpayer provided over 50% of the person's total support for the year or
2. No one person provided more than 50% of the person's total support but two or more persons collectively did. The person must be a member of the household or related to each contributor whose support is counted as shared support and must pass the other dependency tests. The exemption can be claimed by any contributor who provided more than 10% of total support. Those sharing support must agree which of them will claim the exemption. Form 2120 (Multiple Support Declaration) must be signed by all contributors and filed with the claimant's tax return.

Support of a qualifying relative is summarized in the following table:

Qualifying Relative—Support

Total support includes amounts spent for food, lodging, clothing, education, medical, dental, recreation, transportation and other necessities.

- Items not included in total support:
    - Life insurance premiums.
    - Income taxes and social security taxes paid by the dependent.
    - Funeral expenses.
    - Scholarships received by a dependent who is a full-time student.
- **Lodging.** If the person lives in his own home, fair rental value of home is considered support that person contributes. If the taxpayer provides the person's lodging, the fair rental value of such lodging is treated as support provided by the taxpayer.
- **Use of funds.** Amounts a person receives are not support unless actually spent for support.
- **Borrowed funds.** Borrowed funds used for support are counted when support is furnished, not when repaid.
- **Home for the aged.** Lump-sum contributions covering a parent's stay in a home for the aged must be prorated over the parent's life expectancy to determine annual support.
- **Foster care payments.** Third-party payments made to the taxpayer for care of a foster child are not considered support paid by the taxpayer.

Example: Support.

Jane's son Peter is 22 years old and not a full-time student or disabled. Peter's gross income is $2,500 and Jane provides 75% of his support; Peter's grandmother provides the other 25% of his support. Peter is not a qualifying child of Jane or his grandmother because he fails the age test. However, Jane may claim Peter as a dependent under the rules for a qualifying relative. Peter meets the relationship test because he is Jane's son, the gross income test because his income is less than $3,700 and the support test because Jane provides over half of his support.

Children of Divorced or Separated Parents

A child who receives more than half of his support from his parents during the year and is in the custody of one or both of them for more than half of the year is normally the qualifying child of the custodial parent. However, the noncustodial parent can treat the child as his or her qualifying child or qualifying relative if all of the following apply:

1. The parents are divorced, legally separated or lived apart at all times during the last six months of the calendar year,
2. One or both parents provide more than 50% of the child's support for the year,
3. One or both parents had custody for more than half the year, and
4. The custodial parent signs a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent attaches the declaration to his or her return (or a pre-1985 decree or agreement stipulates that the noncustodial parent may claim the exemption and the noncustodial parent provided at least $600 of support).

Custodial Parent. A child's *custodial parent* is the parent who has custody of the child for the greater portion of the year. According to the Form 8332 instructions (revised January 2010) the custodial parent is the parent with whom the child lived for the greater part of the year. Final regulations (generally effective starting in 2009) clarify this by stating that the custodial parent is the parent with whom the child resides for a greater number of nights during the calendar year.

Releasing the Exemption to the Noncustodial Parent. Form 8332 is generally used to release an exemption for the current year or for any or all future years. It can be used even if the parents were never married (*King*). A copy must be attached to the noncustodial parent's return for each year the exemption is released.

In 2008 and prior years, a statement containing all the information as Form 8332 could have been used. However, the Tax Court has denied exemptions to noncustodial parents when substitute documentation did not meet all of the requirements of Form 8332 (*Burke*).

Starting in 2009, a copy of the divorce decree will not suffice to transfer the exemption to the noncustodial parent. Only Form 8332 (or a statement with the same information) will suffice.

Excerpts from Divorce or Separation Agreement. If the divorce or separation agreement states that (1) the noncustodial parent can claim the child as a dependent without regard to any condition (such as payment of support), (2) the other parent will not claim the child as a dependent, and (3) the years to which the claim is released, the noncustodial parent can claim the child by attaching the following pages from the decree or agreement in lieu of using Form 8332:

- Cover page that includes the other parent's SSN.
- Pages that include the information described in items 1–3 above.
- Signature page with other parent's signature and date of agreement.

Effect of a Release. The release of an exemption from the custodial parent to the noncustodial parent only applies for purposes of claiming a dependency exemption and child tax credit for the child.

Parents Claiming an Exemption for a Married Child

A parent can claim a married child as a dependent if the rules for a qualifying child or a qualifying relative (discussed earlier) are met. The child generally must file as married filing separately for a parent to claim a dependency exemption. However, the child can file a joint return, and the parents can still claim him as a dependent if (1) neither the child nor his spouse is required to file a return, (2) neither the child nor his spouse would have a tax liability if they filed separate returns, and (3) a joint return is filed solely to get a refund.

In some instances, it will be more beneficial for the married child to be claimed as a dependent on the parent's return (and the child's spouse to file a married filing separate return). In other situations, the tax cost for the family group will be lower if the child files a joint return with his spouse.

Claiming the Exemption in Multiple Support Situations

Generally, a taxpayer can claim a dependency exemption for a qualifying relative only if he provides more than half of that individual's support for the year, assuming all the other tests for a qualifying relative are met. In some cases, several taxpayers jointly provide support for an individual (e.g., several children support an elderly parent). If no one taxpayer provides more than half the support, the support test under the qualifying relative rules will not be met by any of them. The support test only applies in the case of a qualifying relative; there is no support test for a qualifying child. Therefore, multiple support agreements do not apply to the requirements for a qualifying child.

An exception to the support rule exists for multiple support situations. Qualified taxpayers who each provide more than 10% of an individual's support (and more than 50% collectively) can decide among themselves who will claim the exemption. The following requirements must be met before a multiple support dependency exemption can be claimed:

1. The supported person must meet all of the tests for a qualifying relative, except the more than 50% support test.

2. The taxpayer claiming the exemption must obtain the consent of each of the other taxpayers who pay more than 10% of the support and could, except for the more than 50% support test, otherwise claim the supported person as a dependent.

3. The taxpayer claiming the exemption must be able to claim the supported person as a dependent (i.e., a qualifying relative), except for the more than 50% support test.

The exemption does not have to be allocated to the taxpayer providing the most support; however, the taxpayer claiming the exemption must provide more than 10% of the total support.

Only one taxpayer can claim the exemption each year; however, the exemption does not have to be claimed by the same taxpayer each year. Taxpayers eligible to claim the exemption must

enter into a new agreement each year for one of them to claim the exemption. Tax savings are maximized when the exemption is claimed by the person who will derive the most benefit. For example, a taxpayer in AMT will derive no benefit, since personal exemptions are an AMT adjustment item. Likewise, each of the eligible persons' tax brackets must be considered. Generally, the person in the highest tax rate bracket will derive the most tax benefit. However, if AGI is so high that the personal exemption is scaled back (or eliminated) it may be better to let a person in a lower tax bracket claim it.

Form 2120 (Multiple Support Declaration) is provided to allow an eligible taxpayer to claim the exemption in a multiple support situation, although its use is not mandatory. Form 2120 can be attached to either Form 1040 or Form 1040A. In December 2002, Form 2120 was revised to eliminate the signature requirement by the persons who have waived their right to the dependency exemption. Instead, the person claiming the dependent should obtain a signed statement from each eligible person (i.e., person who, absent the support test, would have qualified for the dependency exemption) that contributed over 10% of the dependent person's support.

The statement should waive the eligible person's right to claim the supported person as a dependent and include (1) the calendar year to which the waiver applies, (2) the name of the supported person, and (3) the eligible person's name, address, and social security number. This statement is not filed with the return, but should be kept with the taxpayer's records.

According to Reg. 1.152-3(c), the taxpayer claiming the dependent must attach Form 2120 (or an appropriate written declaration) to the "return for the year of the deduction." The regulation does not state if an amended return qualifies. Realistically, there should be no problem with using a Form 2120 to submit a multiple support agreement on an amended return.

Example: Children supporting elderly parent.

In 2011, three sons, Mike, Robbie, and Chip, each helped support their father, Steve. Steve received $4,000 in social security benefits. Total support provided for Steve was as follows:

Mike	$ 1,400	10%
Robbie	4,300	31%
Chip	4,300	31%
Social security benefits—exempt from tax	4,000	28%
	$14,000	100%

No one son provided more than half of the support; therefore, the sons must first determine which of them is otherwise entitled to claim an exemption for Steve. Robbie and Chip qualify to claim the exemption because they each provided more than 10% of Steve's support. Since Mike provided only 10% of the support, he is not entitled to claim the exemption. If Mike had provided $1 more toward Steve's support, he would have exceeded the 10% threshold and would also have otherwise qualified to claim the exemption.

Assume that Robbie and Chip agree that Robbie will take the exemption in 2011. Robbie must obtain a signed waiver from Chip and complete Form 2120. Mike is not listed as an eligible person on Form 2120 because he did not provide more than 10% of Steve's support.

Example: Children supporting elderly parent (continued).

Caution: Before either Robbie or Chip can claim his father as a dependent, Steve must meet all of the qualifying relative dependency and personal exemption tests, including the gross income test. For instance, while the $4,000 in social security benefits would be considered to be provided by Steve for his own support for the support test, it does not count toward the $3,700 (for 2011) limit for the gross income test if it is excluded from his taxable income. However, other sources of taxable retirement income (e.g., pensions, interest, and dividends) would count toward the $3,700 limit.

In multiple support situations, the taxpayer claiming the dependency exemption can also deduct medical expenses that he pays for the person being claimed as a dependent.

Chapter 2 Exercises

Question 1: Giving up the dependency exemption.

George and Olivia can claim their son, Dhani, as a dependent. Because Dhani holds a part-time job and must file a return, they decide not to claim Dhani as a dependent. Can Dhani take his own exemption on his return? Why or why not?

Question 2: Regular support test for qualifying child.

Part 1: Julian is 18 and lives with his mother Cynthia. He receives one-third of his support from Cynthia and one-third from his uncle Brian, and provides one-third of his own support. Who, if anyone, can claim Julian as a dependent?

Part 2: What are the four tests used to make this determination?

Question 3: Tie-breaking rule for a qualifying child.

Sean is 13, does not provide any of his own support, and lives with his mother Yoko and his grandmother Isoko in the same house for all of 2011. Who is entitled to claim the dependency exemption for Sean? Why?

Question 4: Qualifying child.

Adam and his wife Dorothy live with their 16-year-old daughter Ann and their 23-year-old son John in the family house. Adam and Dorothy have AGI in excess of $400,000. Ann is in high school and does not provide more than 50% of her own support. John is not a full-time student and earns $15,000 in wages while living in the family home. Adam and Dorothy file a joint return and are eligible to claim Ann as a qualifying child, but would receive little benefit from claiming a dependency exemption deduction for her because their AGI is above the phase-out level. Can John, rather than Adam and Dorothy, take the dependency exemption for Ann? Why or why not?

Chapter 2 Exercise Solutions

Question 1: Giving up the dependency exemption.

George and Olivia can claim their son, Dhani, as a dependent. Because Dhani holds a part-time job and must file a return, they decide not to claim Dhani as a dependent. Can Dhani take his own exemption on his return? Why or why not?

Answer: *Dhani cannot take the dependency exemption. The fact that he could be claimed on his parents' return precludes him from claiming his own personal exemption. If George and Olivia do not claim Dhani's exemption, no one will benefit from the $3,700 (in 2011) reduction in income.*

Question 2: Regular support test for qualifying child.

Part 1: Julian is 18 and lives with his mother Cynthia. He receives one-third of his support from Cynthia and one-third from his uncle Brian, and provides one-third of his own support. Who, if anyone, can claim Julian as a dependent?

Answer: *Julian is a qualifying child of his mother Cynthia and thus is her dependent. In order to be a qualifying child of a taxpayer, an individual must satisfy four tests [IRC Sec. 152(c)(1)].*

Part 2: What are the four tests used to make this determination?

Answer:

Relationship—A qualifying child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual.

Residency—Child must have the same principal residence as the taxpayer for more than half the tax year.

Age—Child must be under age 19 at the end of the tax year, a student under age 24 at the end of the tax year, or permanently and totally disabled at any time during the tax year.

Support—The child did not provide more than one-half of his or her own support for the tax year.

Question 3: Tie-breaking rule for a qualifying child.

Sean is 13, does not provide any of his own support, and lives with his mother Yoko and his grandmother Isoko in the same house for all of 2011. Who is entitled to claim the dependency exemption for Sean? Why?

Answer: *Sean fits the definition of a qualifying child from both Yoko's and Isoko's viewpoints. He meets the relationship test for Yoko because he is her son. He meets the relationship test for Isoko because he is Isoko's grandson (i.e., he is a descendant of Isoko's*

daughter). He meets the age, residency, and support tests for both Yoko and Isoko. However, for purposes of the dependency rules, Sean is treated as the qualifying child of Yoko, his parent, if both Yoko and Isoko attempt to claim him. If Yoko and Isoko agree, either one of them (but not both) can claim Sean as a dependent.

Note that the rules defining a qualifying child for the dependency exemption and the resulting tie-breaking rules provide an opportunity for taxpayers and practitioners to plan for the most beneficial use of the dependency exemption (and in most cases, the child tax credit and possibly the earned income credit).

Question 4: Qualifying child.

Adam and his wife Dorothy live with their 16-year-old daughter Ann and their 23-year-old son John in the family house. Adam and Dorothy have AGI in excess of $400,000. Ann is in high school and does not provide more than 50% of her own support. John is not a full-time student and earns $15,000 in wages while living in the family home. Adam and Dorothy file a joint return and are eligible to claim Ann as a qualifying child, but would receive little benefit from claiming a dependency exemption deduction for her because their AGI is above the phase-out level. Can John, rather than Adam and Dorothy, take the dependency exemption for Ann? Why or why not?

Answer: *John can claim Ann as his qualifying child on his return if Adam and Dorothy elect not to claim her. Ann meets the tests to be treated as John's qualifying child. If John claims his sister as a dependent, he will qualify for the $3,700 personal exemption for her, a $1,000 child tax credit because Ann is under age 17, and approximately $2,700 in refundable earned income credit (EIC). When considering the income tax savings of the dependency exemption, having John claim Ann's dependency exemption has saved the family almost $4,200 in tax.*

The important facts in this case are that the older child (John) claiming the younger child resides in the same household, and the older child cannot be a qualifying child of the parents if he or she is going to claim a dependency exemption or earned income credit (EIC) for the younger sibling (IRC Secs. 32(c)(1)(B) and 152(b)(1)). Thus, this strategy worked because John was not a full-time student under age 24. Also, the older child must have earned income in order to claim the EIC and the younger child must be under age 17 for the $1,000 child tax credit to apply.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Tom and Patricia Smith can claim their daughter Mary as a dependent. Because Mary holds a part-time job and must file a return, they decide not to claim Mary as a dependent. Is Mary allowed to take her own exemption on her return?

    a. Yes.

    b. No.

5. In the current year, Carrie lived five months with her father David and seven months with her mother Diane and her mother's fiancé Bill, (who provided for the majority of the household expenses). Which individual may claim Carrie as a dependent?

    a. David.

    b. Diane.

    c. Bill.

6. Vang and her two brothers provide 100% of the support for their father. Vang pays 40% of the expenses and the two brothers provide 30% each. Who may be entitled to a dependency exemption for the father?

    a. None.

    b. Vang.

    c. Vang or either of her siblings may qualify.

    d. Vang and both of her siblings qualify to claim one-third of their father's exemption.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

4. Tom and Patricia Smith can claim their daughter Mary as a dependent. Because Mary holds a part-time job and must file a return, they decide *not* to claim Mary as a dependent. Is Mary allowed to take her own exemption on her return? **(Page 17)**

   a. Yes. [This answer is incorrect. Mary is not eligible to claim her own exemption as she is an eligible dependent of her parents. The fact they choose not to claim her is not relevant.]

   b. No. [This answer is correct. Mary is not eligible to claim her own exemption regardless of her parent's decision to not claim her. Per tax law, a dependent may not claim his/her own exemption.]

5. In the current year, Carrie lived five months with her father David and seven months with her mother Diane and her mother's fiancé Bill, (who provided for the majority of the household expenses). Which individual may claim Carrie as a dependent? **(Page 23)**

   a. David. [This answer is incorrect. David doesn't meet the support test because Carrie lived with him less than 50% of the year.]

   b. Diane. [This answer is correct. Carrie lived with her mother for greater than 50% of the year; therefore, her mother can claim her as a dependent.]

   c. Bill. [This answer is incorrect. Bill cannot claim Carrie as a dependent because Bill is not related to her and Carrie did not live with Bill for the entire year.]

6. Vang and her two brothers provide 100% of the support for their father. Vang pays 40% of the expenses and the two brothers provide 30% each. Who may be entitled to a dependency exemption for the father? **(Page 24)**

   a. None. [This answer is incorrect. Vang and her brothers may use Form 2120 to allow one of them to claim the exemption since they each provided more than 10% of their father's support.]

   b. Vang. [This answer is incorrect. While Vang pays a higher percentage than either of her two brothers, she did not provide over 50% of her father's support.]

   c. Vang or either of her siblings may qualify. [This answer is correct. Since Vang and her brothers each provide more than 10% of the father's support, each year Vang or one of her brothers may qualify to claim the father and should have the other siblings sign a multiple support agreement.]

   d. Vang and both of her siblings qualify to claim ⅓ of their father's exemption. [This answer is incorrect. Exemptions are allowed 100% to one qualifying individual and only one taxpayer can claim the exemption each year.]

EXAMINATION FOR CPE CREDIT

Chapter 2

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

4. Dallas is divorced and his two children live with him. His son Mark earned $20,000, is 23 years old and is not a student. His daughter Lisa is age 14, with no income. How many exemptions may he claim including himself?

   a. Two.

   b. Three.

   c. One.

   d. Unable to determine.

5. What must a parent do to meet the support test for a qualifying child?

   a. The parent must provide over half of the child's support.

   b. The parent must provide more than the other parent provided as support if divorced.

   c. The parent must have custody and provide over half the child's support.

   d. The child must not have provided over half of their own support.

6. In which of the following situations can a noncustodial parent claim their child as a dependent?

   a. The custodial parent releases the exemption.

   b. The noncustodial parent provides child support.

   c. The divorce decree is silent on who claims the child's exemption.

   d. The custodial parent has insufficient income to benefit from the exemption.

Chapter 3: Wages and Salaries

Learning Objective

Completion of this chapter will enable you to:

- Report wages and other information from Form W-2.

Introduction

An employer must supply a completed Form W-2 to each employee by January 31 of the year following the year the compensation was paid. This form is used by the employee in preparing his tax return for the year. To accurately prepare the return, the practitioner must be able to interpret and use the information shown on Form W-2 and identify when the W-2 has been improperly or incompletely prepared by the employer.

Analyzing Selected Items Reported on W-2

Form W-2

This is one of the most recognized tax forms for U.S. taxpayers. This section will discuss the importance of reviewing all of the information provided on Form W-2, and what to do if some of the information is either incorrect or missing.

22222 Void ☐	a Employee's social security number	For Official Use Only ▶ OMB No. 1545-0008	
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 Code
		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

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

Form **W-2** Wage and Tax Statement 2011

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see back of Copy D.

Cat. No. 10134D

Copy A For Social Security Administration — Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable.

Do Not Cut, Fold, or Staple Forms on This Page — Do Not Cut, Fold, or Staple Forms on This Page

Form W-2, Wage and Tax Statement, has become increasing complex. With electronic filing, there is increased importance in entering every item.

Enter every line item from the W-2 in your software. Tax savings can be discovered. For example, entering retirement contributions often trigger a low income saver's credit.

Important Boxes and Codes

Most Form W-2s include details on wages, withholding, and retirement plan participant information in several boxes, including the following:

- Box 1—Wages, tips, other compensation.
- Box 2—Federal income tax withheld.
- Boxes 3 and 4—Social security wages and tax withheld includes compensation not taxable for income tax purposes but taxable for Social Security up to the maximum amount. For 2011, this amount is $106,800.
- Boxes 5 and 6—Medicare wages and tips and tax withheld includes the same compensation as Box 3 but is not capped.
- Box 7—Social security tips reported to the employer which should already be included in Box 1.
- Box 8—Allocated tips determined by the employer that are allocated to the employee but are **not** included in compensation in Boxes 1, 3, 5, or 7.
- Box 9—Advanced Earned Income Credit received by the employee. Any entry in this box requires the filing of a return regardless of income.
- Box 10—Dependent Care Benefits that must be entered on Form 2441 (Child and Dependent Care Expenses).
- Box 11—This box shows the amount of distributions the employee received from any nonqualified deferred compensation plan or Section 457 plans for nongovernment and tax-exempt organizations. The amount is also included in box 1 compensation [except for distributions from Section 457 plans of state and local governmental agencies which generally must be reported on Form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-sharing Plans, IRAs, Insurance Contracts, etc.)]. In addition to distributions, employer contributions to deferred compensation plans are reported here when such amount is for a prior year's services but included in social security and Medicare wages shown in boxes 3 and 5.
- Boxes 12a–12d—These boxes are for the employer to disclose certain employee information. Some of these items are informational only. However, items with the following codes generally require further action by the preparer.

Code

C	The amount of employer-provided group-term life insurance is included in boxes 1, 3 (up to the social security wage base), and 5 for the cost of coverage in excess of $50,000. (See Codes M and N for treatment of uncollected social security and Medicare taxes when the insurance is paid for former employees.)
D, E, F, G, H, or S	Contributions made by the employee, including any excess amounts, to certain retirement plans [e.g., 401(k) plans] or annuities are included in these boxes. Employee contributions to SIMPLE IRAs are shown as Code S, while contributions to a SIMPLE that is part of a 401(k) plan are reported as Code D. Also, the "Retirement plan" designation in box 13 should be checked when amounts are reported under any of these codes. If the aggregate elective deferrals shown on all of the taxpayer's W-2 forms exceed the annual limit, the excess must be included in the taxpayer's income for the tax year of the deferral.
K	If the employer made excess "golden parachute" payments to a key corporate employee, they are considered wages (subject to social security taxes and included in box 1). The excess golden parachute payment is subject to a 20% excise tax, payable by the employee. The tax is reported in box 12 (and included in income tax withholding in box 2 if the employer withheld the 20%).
L	Employer reimbursements of employee business expenses based on a per diem, mileage, or other fixed allowance (e.g., for auto or travel expenses) are reported here if the reimbursed amount exceeds the federal per diem rates. Box 12 reports the nontaxable amount (the per diem amount paid, up to the allowable federal rate). Box 1 includes the portion that exceeds the allowable federal per diem amount. However, if the employee is filing Form 2106 to claim employee business expenses in excess of employer reimbursements, this amount must be carried to Form 2106 because it reduces otherwise allowable expenses. Box 12 should not be used for employee business expenses if the total reimbursement is less than or equal to the federal per diem rates.
M, N	If the employer did not collect social security tax (Code M) or Medicare tax (Code N) on the cost of group-term life insurance coverage over $50,000 because the taxpayer is a former employee who received no other wages (and thus the employer had no mechanism for withholding such taxes), the former employee is responsible for paying the employee share of these taxes.
P	Employer reimbursements of excludable moving expenses are included here. This amount is not includable in income (and thus it is not reported in box 1). However, if the employee is filing Form 3903 (Moving Expenses) to claim moving expenses in excess of employer reimbursements, this amount must be carried to Form 3903 because it reduces otherwise allowable expenses.

Code

R, W — Employer contributions to an Archer MSA (formerly called a medical savings account) for the employee are shown here as Code R and contributions to a Health Savings Account as Code W. To the extent it was not reasonable for the employer to believe at the time of payment that such contribution would be excludable from the employee's gross income, the contribution must also be included in box 1 as compensation and boxes 3 and 5 as social security and Medicare wages.

T — Employer-provided adoption benefits and payments an employee receives from his pre-tax contributions to a Section 125 (cafeteria) adoption plan account are reported here.

V — The spread [i.e., fair market value of stock over the exercise price of option(s) granted to the employee with respect to that stock] from the employee's (or former employee's) exercise of nonstatutory stock option(s) are reported here. This amount should also be included in boxes 1, 3 (up to the social security wage base), and 5.

Y — Current year deferrals under a Section 409A nonqualified deferred compensation plan are included here. Any earnings during the year on current year and prior year deferrals must also be reported.

Z — This code indicates income received under a Section 409A nonqualified deferred compensation plan that was included in box 1. This income is subject to an additional tax reported on the employee's Form 1040.

AA — This code is used to report designated Roth contributions to a 401(k) plan.

BB — This code is used to report designated Roth contributions to a 403(b) salary reduction agreement.

DD — Cost of employer-sponsored health coverage. The amount reported with Code DD is not taxable.

EE — Designated Roth contributions under a government section 457(b) plan. This amount does not include contributions under a tax-exempt organization section 457(b) plan.

- Box 13—This space contains three boxes that may have been checked by the employer. Checkmarks in the following boxes will require further action by the practitioner.
  - "Statutory employee" is applicable to employees whose earnings are subject to social security and Medicare tax but not to federal income tax withholding. These persons are considered to be self-employed under the common-law rules and report their income and related expenses on Schedule C. For social security purposes, however, they are considered employees under IRC Sec. 3121(d), and the employer

must withhold social security and Medicare tax. Full-time life insurance agents, traveling salespersons, commission drivers, and certain home workers are common examples of statutory employees.

  - "Retirement plan" is applicable if the employee was an active participant in a qualified retirement plan [including SEPs, SIMPLE IRA, and 401(k) plans] at any time during the year. If this box is checked, the employee may be limited in deducting IRA contributions.

    Note: Employers should check this box only if the employee was an active participant in the retirement plan at any time during the year. However, instances may occur when an employer erroneously checks the box.

  - "Third-party sick pay" is applicable only for a third-party sick pay payer (such as an insurance company) filing a Form W-2 for an insured's employee.

- Box 14—This box can be used by the employer to give additional information to the employee. Such information may include items such as voluntary after-tax contributions to a retirement plan withheld from the employee's pay, the lease value of an employer-provided vehicle (reported in box 1), parsonage allowances, educational assistance payments, union dues, or health insurance premiums deducted from the employee's salary, which may be deductible by the employee.

What to Do if Form W-2 Is Not Received

Follow these steps if the employee either discovers an error or does not receive a Form W-2:

1. Contact the employer as soon as possible and request that the problem be corrected.

2. If the employer does not correct the problem, contact the IRS at (800) 829-1040 to report the problem (but not before February 15). The IRS will assist the taxpayer in preparing Form 4852 (Substitute for Form W-2, Wage and Tax Statement or…) showing an estimate of the taxpayer's wages and tax withholding (generally based on the employee's final pay stub for the year). The IRS will then prepare Form 4598 (Form W-2 or 1099 Not Received, Incorrect, or Lost) for contacting the employer about the delinquent W-2. The IRS will mail the taxpayer copies of Forms 4852 and 4598.

3. If the situation is not corrected as the tax filing deadline approaches, the employee can still file his return using the estimated amounts with Form 4852 attached to the return. If a Form W-2 showing different amounts is subsequently received, an amended return must be filed.

Chapter 3 Exercises

Question 1: W-2.

Part 1: Where is the amount in Box 1 of the W-2 reported on the Form 1040?

Part 2: Where is the amount in Box 2 of the W-2 reported on the Form 1040?

Part 3: Where is the amount in Box 17 of the W-2 reported on the Form 1040?

Part 4: What could cause the amounts in boxes 1, 3 and 5 to be different?

Part 5: For most taxpayers, the amounts in boxes 3 through 6 will not appear on the Form 1040. Why is this information included on the W-2?

Part 6: What should you do if the taxpayer's address is wrong?

Chapter 3 Exercise Solutions

Question 1: W-2.

Part 1: Where is the amount in Box 1 of the W-2 reported on the Form 1040?

Answer: *1040 Page 1 Line 7.*

Part 2: Where is the amount in Box 2 of the W-2 reported on the Form 1040?

Answer: *1040 Page 2, Line 62.*

Part 3: Where is the amount in Box 17 of the W-2 reported on the Form 1040?

Answer: *Itemized deduction on Schedule A which flows to Form 1040 Page 2 Line 40. Also state income and taxes paid will be entered on the taxpayer's state tax returns.*

Part 4: What could cause the amounts in boxes 1, 3 and 5 to be different?

Answer: *Any of the following:*

Social security wages are capped at $106,800 for 2011.

Contributions to a qualified retirement plan are excluded from box 1 (i.e., pretax).

Social security wages could be zero for certain government employees.

Part 5: For most taxpayers, the amounts in boxes 3 through 6 will not appear on the Form 1040. Why is this information included on the W-2?

Answer: *1) A copy of the W-2 is sent to the Social Security Administration to track contributions for the purpose of calculating retirement benefits. 2) If a taxpayer has more than one W-2, then social security withholdings could have exceeded the maximum required annual contribution of $106,800 (2011) and the taxpayer could be due a refund.*

Part 6: What should you do if the taxpayer's address is wrong?

Answer: *An old or incorrect address on a W-2 will not preclude the filing of the tax return. The IRS updates its address information based upon the last filing. Therefore, the filing of the 1040 with the proper address will override any previous or incorrect addresses. Inform the taxpayer, so that he or she may inform their employer.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. When reviewing a client's Form W-2, which of the following is most likely to explain a difference between the amounts in boxes 1 and 3?

   a. A client contributes to a retirement plan resulting in wages in box one exceeding box three.

   b. A client receives taxable fringe benefits in addition to their salary.

   c. A client receives taxable wages exceeding $106,800 in 2011.

   d. A client is a statutory employee and reports income on Schedule C.

8. Form W-2 information includes wages, withholding and which of the following?

   a. Fringe benefits and retirement savings.

   b. Cafeteria plan contributions.

   c. Employer contributions into retirement plans.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

7. When reviewing a client's Form W-2, which of the following is most likely to explain a difference between the amounts in boxes 1 and 3? **(Page 36)**

   a. A client contributes to a retirement plan resulting in wages in box one exceeding box three. [This answer is incorrect. A contribution to a retirement plan would lower box one wages not box three.]

   b. A client receives taxable fringe benefits in addition to their salary. [This answer is incorrect. Compensation in whatever form is subject to both income tax and payroll tax.

   c. A client receives taxable wages exceeding $106,800 in 2011. [This answer is correct. Wages are subject to social security up to the maximum amount of $106,800.]

   d. A client is a statutory employee and reports income on Schedule C. [This answer is incorrect. This would not necessarily result in a difference between boxes 1 and 3.]

8. Form W-2 information includes wages, withholding and which of the following? **(Page 36)**

   a. Fringe benefits and retirement savings. [This answer is correct. Certain fringe benefits, dependent care spending accounts and employee deferrals are all included on Form W-2.]

   b. Cafeteria plan contributions. [This answer is incorrect. While some contributions for daycare benefits or Health Savings Accounts are notated, the contributions to cafeteria plans are not disclosed.]

   c. Employer contributions into retirement plans. [This answer is incorrect. Employee deferrals are included in Box 12 but not the employer's contribution.]

EXAMINATION FOR CPE CREDIT

Chapter 3

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

7. Box 1 of Form W-2 represents:

   a. Earnings subject of social security taxes.

   b. Earnings subject to Medicare tax.

   c. Earnings subject to federal income tax.

   d. Earnings before contributions to retirement accounts.

8. Parch's W-2 has an amount in box 12 for $16,500. What is the most likely explanation for this amount?

   a. Parch's employer has made a contribution to his retirement account in the amount of $16,500 and has included this in his taxable wages.

   b. Parch's employer as made a contribution to his cafeteria plan in the amount of $16,500 and has excluded this from his taxable wages.

   c. Parch has elected to contribute $16,500 into his tax deferred retirement account and the amount is excluded from his taxable wages.

   d. Parch has elected to contribute $16,500 into his cafeteria plan and the amount is included in his taxable wages.

Chapter 4: Interest and Dividend Income

Learning Objectives

Completion of this chapter will enable you to:

- Determine the tax rate applicable to qualified dividends.
- Explain the tax treatment when bonds are purchased at a premium or a discount, and describe the treatment of interest on government bonds.

Introduction

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Tax Act) significantly reduced the tax rate on qualified dividends. Thus, identifying qualified dividends is critical.

The amount of reportable interest and dividend income is not always apparent. It can be obscured by transactions such as purchasing a bond between interest payment dates. The practitioner must also make sure that the income is reported (1) under the proper classification, (2) in the proper year [companies often pay (and report) fourth-quarter dividends on December 31 that are not received by cash-basis taxpayers until the following year], (3) as received from the proper payer, and (4) by the proper taxpayer (in many family situations, earnings are reported to a nominee owner). Failure to recognize these issues can result in IRS correspondence, unbillable time, and client ill will.

Interest income and expense are determined under special rules when the related debt instrument carries a below-market interest rate.

While the receipt of tax-exempt interest generally is not taxable for regular tax purposes, the income can affect other computations in the taxpayer's return. For example, interest income on certain private activity bonds (issued after August 7, 1986) is not taxable in computing regular tax but is included as a tax preference item in computing alternative minimum tax (AMT). However, the Housing Assistance Tax Act of 2008 exempts interest on specific types of tax-exempt housing bonds issued after July 30, 2008 from being included as a preference item for AMT purposes. Also, tax-exempt interest is included in computing taxable social security benefits, impacts the computation of the earned income credit, and results in disallowance of expenses incurred to carry the investment generating tax-exempt income. The practitioner should also consider the state income tax ramifications.

New Law: Tax-exempt interest on private activity bonds issued in 2009 and 2010 is not subject to AMT. Refunding bonds generally are treated as issued on the date of the refunded bond, unless the refunded bond was issued during 2004–2008. (American Recovery and Reinvestment Act of 2009)

Qualified Dividends Taxed at Lower Rates

Dividends Taxed at Capital Gain Rates

Under the 2003 Jobs and Growth Tax Relief Act, qualified common and preferred dividends received by an individual shareholder (or estate or trust) from domestic corporations and certain foreign corporations are taxed at the same rates as adjusted net capital gain.

The following table shows the maximum tax rates for qualifying dividends:

Year in which received:	2003–07	2008	**2009–12**	2013
To the extent otherwise taxed at 10% or 15%	5%	0%*	**0%***	15%
To the extent otherwise taxed at 25% or higher	15%	15%*	**15%***	Up to 39.6%

*First time this rate applies

** TIPRA 2005 (signed into law in 2006) extended the lower capital gain and dividend tax rates through 2010 and the TRA of 2010 extended these rates through 2012, after which they are scheduled to return to pre-2003 rates.

Qualified dividends are distributions of:

1. Current earnings and profits (E&P) of a C corporation; or

2. Accumulated earnings and profits (AE&P) of a C corporation.

An S corporation can only pay dividends from AE&P generated while it was a C corporation. Thus, a corporation that has always been an S corporation cannot issue a qualified dividend.

To be “qualified” the shareholder must have held the stock for the required period:

1. For common stock, the taxpayer must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (which is the first date following the declaration of the dividend on which the buyer of a stock will not receive the dividend).

2. For preferred stock if the dividends are attributable to a period of more than a year, the taxpayer must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date.

Dividends from a tax-exempt corporation (including a corporation with that status for the year before the distribution) and dividends allowed as a deduction under IRC Sec. 591 (relating to mutual savings banks and certain other savings institutions) fail to qualify for the reduced tax rate.

Pass-through Entities. Partnerships (including LLCs taxed as partnerships) pass qualified dividend income through to noncorporate partners, where the dividends are taxed at the favorable rates. S corporations (including LLCs taxed as such) also pass through qualified dividends (received from corporations in which the S corporation holds stock) to their noncorporate shareholders because the character of a pass-through item from an S corporation is determined as if the pass-through item were realized directly from the source. Also, qualified dividends received by a single-member LLC that is treated as a disregarded entity should be treated as if they were received by the LLC member.

Because REITs normally invest in real estate and pay no entity-level tax, they will rarely pay dividends eligible for the reduced rates. However, to the extent they are attributable to (1) dividends the REIT received from taxable non-REIT corporations after 2002 or (2) income on which the REIT paid tax (e.g., undistributed income) less the amount of tax the REIT paid on that income, REIT distributions should qualify for the lower rate.

Mutual Fund Dividends. Although most distributions from mutual funds (i.e., regulated investment companies) are referred to as dividends, mutual fund distributions will qualify for the reduced tax rate on dividends only to the extent the amount is attributable to qualified dividends received by the fund. To the extent mutual fund distributions are attributable to items such as interest and short-term capital gains, they will not qualify (although distributions attributable to long-term capital gains continue to qualify for the preferential long-term capital gain rate).

Mutual funds have historically identified to their shareholders the amount of their distributions attributable to long-term capital gains. Form 1099-DIV includes a box for qualified dividends, which will ensure that payers, including mutual funds, will also identify the amount of any qualified dividends.

Qualified Foreign Corporations. Qualified dividends include otherwise qualified dividends received from qualified foreign corporations. A qualified foreign corporation is a corporation (1) incorporated in the U.S. or a U.S. possession, (2) whose shares [or an American Depository Receipt (ADR) backed by such shares] are readily tradable on an established U.S. securities market, or (3) eligible for benefits of a comprehensive income tax treaty with the U.S. that the Treasury Secretary determines is satisfactory for purposes of the reduced tax rate on dividends and includes an exchange of information program.

Dividends from a foreign corporation will not qualify for the reduced tax rate if they were paid by a foreign corporation that for the current or immediately prior tax year was a Section 552 foreign personal holding company, a Section 1246(b) foreign investment company, or a Section 1297 passive foreign investment company.

Any foreign tax credit allowed with respect to dividends eligible for the reduced tax rates will be scaled back under rules similar to those imposed by IRC Sec. 904(b)(2)(B) relating to certain capital gains. This prevents the taxpayer from claiming a foreign tax credit greater than the U.S. tax paid on that income.

How Qualified Dividends Are Taxed

The 0% and 15% maximum capital gain tax rates are applied to qualified dividends by treating them (for tax calculation purposes only) as long-term capital gains for both regular and AMT purposes. However, to prevent dividend income from being offset by capital losses [except to the extent that up to $3,000 ($1,500 for married filing separate returns) of net capital loss can be deducted against ordinary income (including dividends) for any tax year] the tax calculation on capital gains includes the concept of adjusted net capital gain.

Planning Tip: Because qualified dividends are taxed at the same rate as long-term capital gains for both regular and AMT purposes, taxpayers should be aware that exposure to AMT increases substantially with large qualified dividends and capital gains. This can potentially cause a phase-out in the AMT exemption which indirectly may trigger AMT.

Adjusted net capital gain is determined after net capital gain is calculated. Net capital gain is the excess of (1) net long-term capital gain over (2) net short-term capital loss. Adjusted net capital gain is then computed by (1) reducing net capital gain (but not below zero) by (a) capital gain attributable to depreciation of Section 1250 property (i.e., 25% rate capital gains) and (b) 28% rate capital gains and (2) adding qualified dividend income.

Reporting Dividends. Although they are taxed at the long-term capital gain rate, qualified dividends are reported (along with nonqualified dividends) on Schedule B. Total dividend income is carried to line 9a of Form 1040, where it is included in the calculation of AGI. Total qualified dividends are entered on line 9b (a memorandum line) and then carried to the tax computation using maximum capital gains rates.

Election to Treat Qualified Dividends as Investment Income. Investment interest expense is deductible generally only to the extent of net investment income. Qualified dividend income is not treated as investment income for purposes of IRC Sec. 163. However, taxpayers can elect to treat qualified dividend income as investment income. If the election is made, the dividends treated as investment income will not qualify for taxation at the reduced rates. (A similar rule applies to long-term capital gains.) This gives taxpayers the choice of applying the favorable tax rates to qualified dividend income or using qualified dividend income to offset investment interest expense.

Securities Purchased at a Discount

When a debt security is acquired at less than the stated redemption amount (i.e., at a discount), the difference can be due to either original issue discount (OID), market discount, or both. OID arises at the original purchase (issue) of a debt security, while market discount can occur anytime subsequent to its issuance.

Original Issue Discount Bonds

When a debt security (such as a bond) is issued at less than the stated redemption price (i.e., at a discount), the difference is referred to as OID. Under IRC Sec. 1272(a), OID is included in the holder's income over the security's term using the constant rate method.

Reporting OID. Taxpayers holding debt instruments (bonds) with OID should receive a Form 1099-OID showing the amount of OID income for the year. The 1099-OID will also show any periodic interest paid on the security for the tax year. Both the OID and the periodic interest must be reported.

In certain situations, however, the OID shown on the Form 1099-OID must be recomputed. Recomputing OID is needed when:

1. The debt instruments were purchased at a premium or acquisition premium. When purchased at a premium (i.e., a cost that exceeds the total of all remaining principal payments), no OID is reported. If purchased at an acquisition premium (i.e., a cost that exceeds the original issue price increased for prior OID, but less than the total of all remaining principal payments), the amount of OID to report will be less than that shown on the Form 1099-OID.

2. The debt instrument is a stripped bond or coupon (including zero coupon bonds available through the U.S. Treasury Department's STRIPS program). These include, for example, CATS, TIGRs, and TIPs.

When reporting OID that includes an adjustment, the amount of OID shown on the Form 1099-OID should be shown on Schedule B followed by the adjustment identified as "OID Adjustment."

Example: Debt instrument purchased at an acquisition premium.

Albert acquires an Acme Corp. bond with a face value of $10,000 on February 1, 2011, for $9,900 (after adjusting for purchased interest). The 20-year bond was originally issued on June 1, 1995, for $9,000 and on the date Albert acquired it, the accumulated OID was $734. Thus, Albert's acquisition premium is $166, the difference between his cost ($9,900) and the adjusted issue price of the bond ($9,000 + $734). The $166 acquisition premium reduces the OID Albert recognizes over the remainder of the bond's term.

For 2011, Albert received a Form 1099-OID showing $45.87 of OID. Albert makes a $28.62 [($45.87 sum of daily OID amounts for 2010 × $166 acquisition premium) ÷ $266 remaining OID at Albert's purchase date] adjustment to this amount for the acquisition premium he paid. (The Form 1099-OID would also show any interest Albert received from the bond for 2011. He would report this on his Schedule B, but because the bond was acquired between interest payment dates, an adjustment for the purchased interest is required.)

Variation 1: Had Albert paid $10,100 for the bond, there would be a premium of $100 (cost of $10,100 – $10,000 of remaining principal payments on the bond). Here, there is a premium (rather than an acquisition premium), so Albert does not report any OID while he holds the bond.

Variation 2: Had Albert paid $9,500, his cost would be less than the adjusted issue price of $9,734. Thus, he would have $234 ($9,734 – $9,500) of market discount in addition to $266 ($10,000 – $9,000 – $734) of remaining OID on the bond.

IRS Pub. 1212, "List of Original Issue Discount Instruments," contains information to help owners of publicly offered OID debt instruments determine how much OID to report on their income tax returns. Original issue discount tables previously listed in IRS Pub. 1212 are now only available on the IRS website at **www.irs.gov/formspubs/article/0,,id=109875,00.html**.

The owner of an OID bond may sell or redeem it before maturity. Capital gain or loss on the sale or early redemption is determined by the difference between the sales price and the bond's basis (original cost plus OID accrued and included in the bondholder's income to date). If the bond is held to maturity, no gain or loss results from the redemption because the bond's basis is equal to its face value (unless the bond was acquired in the secondary market at a premium or discount and the taxpayer did not elect to accrue the discount or amortize the premium—see the following discussion). However, the taxpayer must still report the redemption on Schedule D.

***De minimis* OID.** OID is ignored if the discount is less than a *de minimis* amount. The *de minimis* amount is .25% of the stated redemption price at maturity, multiplied by the number of complete years from the date of original issuance to maturity. When OID is considered *de minimis*, the regular OID rules do not apply. Instead, *de minimis* OID is included in the bondholder's income as principal payments are received. The amount of *de minimis* OID to be included in income equals the *de minimis* OID multiplied by a fraction. The numerator of the fraction is the amount of the principal payment received, and the denominator is the bond's stated principal amount.

Example: *De minimis* OID amount.

A bond issued on January 1, 2011, is redeemable on September 15, 2013, for $100,000. The *de minimis* amount is .25% × $100,000 × 3 years, or $750. Accordingly, if the issue price exceeds $99,250 (but is less than $100,000), any OID is considered *de minimis* and is included in income as principal payments are received. In this example, all the *de minimis* OID is included in the bondholder's income at maturity because the bond calls for only one payment of principal at maturity.

OID on Tax-exempt Bonds. Tax-exempt bond OID is not subject to tax. However, if a tax-exempt bond is sold before maturity, a capital gain or loss could arise when the selling price is compared to the sum of the acquisition price plus any OID interest accrued through the date of sale.

Example: Tax-exempt bond OID.

David purchased a 10-year, zero coupon, $1,000,000 New Hampshire Municipal Bond at original issue for $700,000. The yield is 4%. Two years later, David sells the bond to Pele for $ 770,000 when the accrued OID is $57,120. At the time of the sale David's basis is $757,120 ($700,000 plus $57,120) therefore he recognizes a capital gain of $12,880 ($770,000 – 757,120).

Pele will amortize (deduct) the $12,880 premium he paid over the remaining life of the bond. If Pele holds the bond until maturity, he will recognize no gain or loss because his basis will be $ 100,000, computed as follows:

Cost (what Pele paid David)	$ 770,000
OID during Pele's holding period:	
$300,000 less David's OID of $ 57,120	242,880
Less premium amortization during holding period	(12,880)
Pele's basis at sale of bond	$ 1,000,000

Securities Purchased at a Premium

When a bond is purchased at a price greater than the amount payable at maturity, it is called a premium bond.

Example: Premium bond.

A bond is paying a higher rate of interest than the current market conditions. Due to favorable interest rates, the bond is sold in the secondary market for $110. The bond matures at $100. Thus the bond was purchased at a $10 premium.

The taxpayer has two options:

1. To amortize the premium, which reduces the current income of the bond by a portion of the premium each year, or

2. Not to amortize the premium, and potentially take a capital loss deduction when the bonds are sold, called or mature.

Amortization:

- For bonds purchased before October 23, 1986, the bond premium amortization is treated as a miscellaneous itemized deduction not subject to the 2% AGI limitation.
- For bonds purchased on or after October 23, 1986, but before 1988, premium amortization is generally treated as investment interest expense.
- For bonds acquired after December 31, 1987, the premium bond amortization is a direct offset to interest income.

Tax-exempt bonds. Interest from state and local government bonds is exempt from federal tax. Original issue discount increases the amount of tax-exempt income and the adjusted tax basis of the bond. Any discount not attributable to OID is not tax exempt. If a bond is issued at par or above, but is purchased at a discount, the basis to the taxpayer is the purchase price (exclusive of accrued interest). A disposition at an amount more than the taxpayer's basis will result in a taxable gain. A bond premium must be amortized to determine the taxpayer's adjusted basis.

The amortization is not a tax deduction, but merely a reduction in the cost basis of the bond. Amortization is necessary to avoid creating a capital loss upon sale or maturity that would relate to tax-exempt interest.

Offsetting Income for Purchased Interest

When bonds are purchased between interest payment dates, accrued interest is built into the purchase price and effectively paid to the seller at the time of sale. While this "purchased interest" is taxable to the seller, the purchaser may receive a Form 1099 showing the total interest paid for the year. Thus, an adjustment is required to report the correct amount of interest on Schedule B.

When a bond purchaser receives a Form 1099 that includes accrued interest paid to the seller (as part of the purchase price), the amount of purchased interest should be identified as "Accrued Interest" and subtracted from the total interest shown on the Form 1099.

U.S. Government Bonds

Series EE Bonds

Paper EE bonds are issued at a discount (bond with a $50 face value is purchased for $25) and pay all interest at redemption or maturity. Electronic EE Bonds are issued at face value (bond with a $50 face value is purchased for $50).

Interest is subject to federal income tax, but not to state or local income tax. Interest is not taxable until the year the bonds are cashed (bond owner will receive a Form 1099-INT) or the year the bonds mature (bond owner must determine the interest to report).

Taxpayer may elect to report interest annually as it accrues. Once the election is made, it applies to all Series E/EE bonds owned by the taxpayer and those acquired later. The election must be made on a timely filed return.

Interest earned on certain EE bonds used to pay for college tuition may be tax free.

EE bonds purchased after April 30, 1997, and before May 1, 2005, earn interest based on 90% of the average yields on five-year Treasury securities for the preceding six months. These bonds increase in value every month and interest is compounded semiannually. If the bond does not reach its face value after 17 years, a one-time adjustment is made to increase the bond's redemption value to its face value.

Series EE Bonds issued after April 30, 2005, earn a fixed interest rate that depends on the issue date. The rate applies for at least 20 years. These paper Series EE bonds are guaranteed to reach the stated maturity value (double the issue price) after 20 years or the value will be adjusted accordingly. Bonds must be held five years prior to redemption to avoid a three-month interest penalty.

EE bonds may be owned by:

- *Single Ownership.* Adult or minor.
- *Co-ownership (two persons).* Either co-owner may cash the bond. Both must authorize reissue of a co-ownership bond. Interest is generally taxable to the co-owner who bought the bond.
- *Beneficiary.* One owner and another person as beneficiary. Only the owner may cash the bond during the owner's lifetime.

TIN of the owner or first-named co-owner is required.

Co-owners of Series E/EE bonds. The co-owner who cashes a bond is issued a Form 1099-INT reporting the accumulated interest. If the bond is cashed by the co-owner who did not purchase the bond, the individual cashing the bond should give a nominee Form 1099-INT to the co-owner who purchased the bond (who must pay the tax).

Joint Tenancy EE Bonds. There are two options for reporting deferred interest on EE bonds held in joint tenancy with right of survivorship when one spouse dies.

1. Include the deceased spouse's share of interest on the decedent's final income tax return, and the surviving spouse pays tax only on the amount of interest accumulated after death, or

2. All interest is taxed when the bonds are cashed.

Savings Bond Redemption Calculator

The Bureau of the Public Debt website computes the redemption values for Series EE savings bonds. Enter the denomination (face value) and issue date of a bond, and the current redemption value is computed. See the Savings Bond Calculator link at **www.treasurydirect.gov**.

Series HH Bonds

The Treasury stopped issuing new Series HH bonds after August 31, 2004. Series HH bonds were issued at face value. They pay interest semiannually at a fixed rate and are subject to federal income tax, but not subject to state or local income tax.

Series HH bonds were only issued in exchange for Series E and EE bonds. The attractive feature of Series HH bonds is that deferred accrued interest on the Series E and EE bonds continues to be deferred until the Series HH bonds mature. Interest earned on the HH bond portion cannot be deferred.

Treasury Inflation Protection Securities (TIPS)

Inflation-indexed treasury securities are sold in minimum increments of $1,000. The difference between inflation-indexed bonds and other government bonds is that the principal is adjusted up or down for inflation or deflation in addition to having a fixed interest rate.

The interest portion is paid semiannually, but the inflation-adjusted principal amount is not paid until the note matures. Investors are liable for federal income taxes on the yield under the OID rules.

Inflation/deflation Adjustments to Income. Taxpayers must include any positive inflation adjustment in ordinary income for the year of the adjustment. Negative adjustments for deflation are an ordinary loss. However, the loss cannot exceed the amount of income on the bond reported in prior years. Any remaining negative adjustment is carried forward to offset income from the bond in subsequent years.

Series I Bonds

I bonds are available in denominations of $50, $75, $100, $200, $500, $1,000, $5,000 and $10,000. They are issued at face value and all interest paid at redemption or maturity.

The interest rate is a combination of two separate rates: (1) a fixed rate of return that remains the same for the life of the I bond, and (2) a semiannual inflation rate that can vary every six months. The semiannual inflation rate is based on the Consumer Price Index for all Urban consumers (CPI-U). Interest earnings are added each month and are compounded semiannually.

The interest is subject to federal income tax, but not to state or local income tax. Federal income tax may be deferred until the earlier of the year the bonds are cashed or the year they mature (30 years). A cash basis taxpayer may elect the accrual method for Series I bonds (same rule as for Series EE bonds), in which case the interest is taxed annually. This might be especially beneficial to a child in a low tax bracket.

If the bond is redeemed to pay for college tuition or other college fees, all or part of the interest may be excludable from income if modified adjusted income is under an annual phase-out limit. This is the same exclusion rule as for EE bonds used for tuition.

Status of Older Savings Bonds/Savings Notes

Most bonds/notes are earning interest, but some have reached the final maturity dates set by the Treasury and no longer earn interest.

How Long Bonds Earn Interest		
Series	***Date of Issue***	***Interest-bearing Life***
E	May 1941–November 1965 December 1965–June 1980	40 Years 30 Years
H	February 1957–December 1979	30 Years
Saving Notes	All Issues	30 Years
EE	All Issues	30 Years
HH	All Issues	20 Years
I	All Issues	30 Years

More information about U.S. savings bonds, Treasury bills and notes, government securities, etc., is available from the Bureau of the Public Debt (**www.treasurydirect.gov**).

Chapter 4 Exercises

Question 1: Combined statements.

Your client provides to you a statement from their investment company. On page one of the combined statement is a summary of all the interest and dividend income for all the investments held by the taxpayer. On pages two through 7 are details of the interest and dividend income segregated by each investment company. When you are entering the interest and dividend information on Schedule B of the Form 1040, do you enter the information in summary or do you include the line item detail?

Question 2: Government and municipal interest.

Part 1: Is U.S. Government bond interest taxable on the federal Form 1040?

Part 2: Is U.S. Government bond interest taxable on state income tax returns?

Part 3: Is Municipal bond interest taxable on the federal Form 1040?

Part 4: Is Municipal bond interest taxable on state income tax returns?

Question 3: Computing adjusted net capital gain.

Stacy Ferguson's marginal tax rate is 35%. During 2011, she receives a $10,000 qualified dividend from Asta, Inc., a U.S. corporation. She also sells two pieces of investment property and recognizes a $7,000 long-term capital gain and a $3,000 long-term capital loss.

Part 1: What is her net capital gain or loss?

Part 2: What is her adjusted net capital gain or loss?

Part 3: At what rate is her adjusted net capital gain taxed?

Question 4: Computing adjusted net capital gain (continued).

Assume the same facts as in Question 3, except that Stacy recognizes a $3,000 long-term capital gain and a $7,000 long-term capital loss in 2011.

Part1: What is her net capital gain or loss?

Part 2: What is her adjusted net capital gain or loss?

Question 5: Purchased interest included on Form 1099.

Will Adams acquires an 8% Acme Corp. bond with a face value of $10,000 on February 1, 2011, for $10,034. The price consisted of $9,900 for principal and $134 for accrued interest. The bond pays interest semiannually on June 1 and December 1. On June 1, 2011, and on December 1, 2011, Will receives $400 interest. He receives a 2011 Form 1099 showing interest income of $800. How should Will report the interest income on Schedule B?

Question 6: Interest and dividend income.

Part 1: Where is the amount in Box 1 of the 1099-INT reported on the Form 1040?

Part 2: Where is the amount in Box 3 of the 1099-INT reported on the Form 1040?

Part 3: Where is the amount in Box 1a and 1b of the 1099-Div reported on the Form 1040?

Part 4: Where is the amount in Box 2a of the 1099-Div reported on the Form 1040?

Part 5: Your client informs you that he has a savings account with a balance of $200 in a local bank and he did not receive a 1099-Int for the interest of $3.50. Why didn't the bank send a 1099-Int? What should you do?

Part 6: You receive a 1099-Div which includes $42 of foreign tax paid in box 6. Do foreign taxes affect the U.S. Form 1040?

Chapter 4 Exercise Solutions

Question 1: Combined statements.

Your client provides to you a statement from their investment company. On page one of the combined statement is a summary of all the interest and dividend income for all the investments held by the taxpayer. On pages two through 7 are details of the interest and dividend income segregated by each investment company. When you are entering the interest and dividend information on Schedule B of the Form 1040, do you enter the information in summary or do you include the line item detail?

Answer: *Interest and dividends can be entered in summary. Detail is optional. Sales of securities must be entered line item by line item.*

Question 2: Government and municipal interest.

Part 1: Is U.S. Government bond interest taxable on the federal Form 1040?

Answer: *Yes*

Part 2: Is U.S. Government bond interest taxable on state income tax returns?

Answer: *Generally No. However dividends derived from holding certain U.S. Government obligations (i.e., U.S. Treasuries) may be exempt from state and local income taxes. However, some state and local rules provide income and asset thresholds that must be satisfied before such dividends can qualify for this benefit. This information is usually provided by the investment broker.*

Part 3: Is Municipal bond interest taxable on the federal Form 1040?

Answer: *No*

Part 4: Is Municipal bond interest taxable on state income tax returns?

Answer: *In general, most states do not tax individuals on the interest income arising from municipal bonds issued by their state of residence, its agencies, or its political subdivisions. However, the reverse is true with respect to bonds issued by out-of-state agencies or political subdivisions—virtually all states tax the interest resulting from such bonds.*

Question 3: Computing adjusted net capital gain.

Stacy Ferguson's marginal tax rate is 35%. During 2011, she receives a $10,000 qualified dividend from Asta, Inc., a U.S. corporation. She also sells two pieces of investment property and recognizes a $7,000 long-term capital gain and a $3,000 long-term capital loss.

Part1: What is her net capital gain or loss?

Answer: *$4,000 ($7,000 – $3,000).*

Part 2: What is her adjusted net capital gain or loss?

Answer: *Her adjusted net capital gain is $14,000 ($4,000 + $10,000).*

Part 3: At what rate is her adjusted net capital gain taxed?

Answer: *15% capital gain rate, resulting in tax of $2,100.*

Question 4: Computing adjusted net capital gain (continued).

Assume the same facts as in Question 3, except that Stacy recognizes a $3,000 long-term capital gain and a $7,000 long-term capital loss in 2011.

Part1: What is her net capital gain or loss?

Answer: *Now, she has a net capital loss of $4,000.*

Part 2: What is her adjusted net capital gain or loss?

Answer: *Since adjusted net capital gain cannot be below zero before adding dividend income, the dividend income cannot be used to offset the capital loss. Thus, adjusted net capital gain is $10,000 and is taxed at 15%. The $4,000 long-term capital loss can be deducted from other income to the extent of $3,000. Taylor will have a $1,000 ($4,000 – $3,000) long-term loss carryover to 2012.*

Question 5: Purchased interest included on Form 1099.

Will Adams acquires an 8% Acme Corp. bond with a face value of $10,000 on February 1, 2011 for $10,034. The price consisted of $9,900 for principal and $134 for accrued interest. The bond pays interest semiannually on June 1 and December 1. On June 1, 2011 and on December 1, 2011, Will receives $400 interest. He receives a 2011 Form 1099 showing interest income of $800. How should Will report the interest income on Schedule B?

Answer: *Will should report the entire $800 of interest on Schedule B to avoid IRS matching problems. Below the $800 amount, he should subtract the $134 of purchased interest.*

Question 6: Interest and dividend income.

Part 1: Where is the amount in Box 1 of the 1099-INT reported on the Form 1040?

Answer: *1040 Page 1 Line 8a.*

Part 2: Where is the amount in Box 3 of the 1099-INT reported on the Form 1040?

Answer: *1040 Page 1 Line 8b.*

Part 3: Where is the amount in Box 1a and 1b of the 1099-Div reported on the Form 1040?

Answer: *1040 Page 1 Line 9a and 9b.*

Part 4: Where is the amount in Box 2a of the 1099-Div reported on the Form 1040?

Answer: *1040 Page 1 Line 13.*

Part 5: Your client informs you that he has a savings account with a balance of $200 in a local bank and he did not receive a 1099-Int for the interest of $3.50. Why didn't the bank send a 1099-Int? What should you do?

Answer: *Normally banks do not send 1099s if interest is less than $10. Include it on Schedule B.*

Part 6: You receive a 1099-Div which includes $42 of foreign tax paid in box 6. Do foreign taxes affect the U.S. Form 1040?

Answer: *Yes. The taxpayer receives a credit for foreign taxes paid. Form 1040 page 2 line 47.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. The tax rate for qualified dividends and interest in 2011 is a maximum of:

   a. 0% for dividends only.

   b. 15% for dividends only.

10. When a taxpayer purchases a bond at a premium (more than face value), the taxpayer should:

    a. Amortize the premium—reducing the current income from the bond.

    b. Take a capital loss (or reduced gain) when the bond is sold or matured.

    c. Amortize the premium or take a capital loss.

11. Interest from certain bonds is exempt from federal income taxes. Which bonds earn tax exempt interest?

    a. Series EE bonds.

    b. Series I bonds.

    c. State and local government bonds.

    d. Treasury Inflation Protection Securities (TIPS).

12. Which of the following statements is correct regarding Series EE and HH bonds?

    a. Individual taxpayers must report interest on Series EE bonds annually as it accrues.

    b. Series EE bonds purchased before May 1, 2005, earn a fixed rate of interest that depends on the issue date.

    c. Interest earned on HH bonds cannot be deferred.

    d. Series EE bonds purchased issued after April 30, 2005, must be held ten years prior to redemption to avoid a three-month interest penalty.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

9. The tax rate for qualified dividends and interest in 2011 is a maximum of: **(Page 48)**

   a. 0% for dividends only. [This answer is incorrect. Some taxpayers in 2009–2012 may benefit from this rate but it is not the maximum rate for dividends.]

   b. 15% for dividends only. [This answer is correct. The rate for the interest income is unknown as it is subject to the graduated tax rates.]

10. When a taxpayer purchases a bond at a premium (more than face value), the taxpayer should: **(Page 52)**

    a. Amortize the premium—reducing the current income from the bond. [This answer is incorrect. This is one of the options available to the taxpayer.]

    b. Take a capital loss (or reduced gain) when the bond is sold or matured. [This answer is incorrect. The taxpayer has another option in addition to taking a capital loss when the bond is sold or matured.]

    c. Amortize the premium or take a capital loss. [This answer is correct. Per current tax law, the taxpayer has an option to either amortize the premium or reflect a capital loss when the bond is sold.]

11. Interest from certain bonds is exempt from federal income taxes. Which bonds earn tax exempt interest? **(Page 53)**

    a. Series EE bonds. [This answer is incorrect. Series EE bond interest is subject to federal income tax, but not to state or local income tax.]

    b. Series I bonds. [This answer is incorrect. Series I bond interest is subject to federal income tax. However, if the bond is redeemed to pay college tuition, all or part of the interest may be excludable from income.]

    c. State and local government bonds. [This answer is correct. Under the Internal Revenue Code, interest from state and local government bonds is exempt from federal income tax.]

    d. Treasury Inflation Protection Securities (TIPS). [This answer is incorrect. Investors are liable for federal income taxes on the yield under the OID rules.]

12. Which of the following statements is correct regarding Series EE and HH bonds? **(Page 55)**

    a. Individual taxpayers must report interest on Series EE bonds annually as it accrues. [This answer is incorrect. Normally, cash basis taxpayers report the interest when redeemed but they may elect to report it as earned.]

    b. Series EE bonds purchased before May 1, 2005, earn a fixed rate of interest that depends on the issue date. [This answer is incorrect. These bonds earn interest based on 90% of the average yield on five-year Treasury securities for the preceding six months.]

    c. Interest earned on HH bonds cannot be deferred. [This answer is correct. Series HH bonds were only issued in exchange for Series E and EE bonds. Interest earned on the Series E and EE bonds is deferred until the Series HH bonds mature but the interest earned on the HH bond portion cannot be deferred.]

    d. Series EE bonds purchased issued after April 30, 2005, must be held ten years prior to redemption to avoid a three-month interest penalty. [This answer is incorrect. These bonds must be held five years prior to redemption to avoid a three-month interest penalty.]

EXAMINATION FOR CPE CREDIT

Chapter 4

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

9. Dividends are taxed at the same rate as:

   a. Interest income.

   b. All ordinary income.

   c. Capital gains.

   d. Capital losses.

10. A corporation cannot issue a qualified dividend if it has always been an S corporation.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

11. How is the bond premium amortization treated for bonds acquired after December 31, 1987?

    a. As a direct offset to interest income.

    b. As a miscellaneous itemized deduction not subject to the 2% AGI limitation.

    c. As investment interest expense.

    d. Do not select this answer choice.

12. From which taxes are U.S. Government bonds exempt?

    a. Federal income taxes.

    b. Both state and federal income taxes.

    c. State income taxes.

    d. None—they are not exempt from any taxing authority.

Chapter 5: Pension and Retirement Income

Learning Objectives

Completion of this chapter will enable you to:

- Determine the taxability of social security benefits.
- Apply the rules relating to distributions from traditional and Roth IRAs and describe how to convert a traditional IRA into a Roth IRA.
- Explain how qualified retirement and IRA distributions can be rolled over into another plan and apply the minimum distribution rules.

Introduction

This chapter covers the taxation of pension and retirement income (including social security benefits and the minimum distribution rules for IRAs and qualified plans).

Calculating Taxable Social Security Benefits

General Rules

Taxpayers may have to include up to 85% of social security benefits (paid because of retirement, survivorship, or disability) in taxable income. The amount of benefits includable in income depends on the taxpayer's "provisional income." Provisional income is the taxpayer's modified adjusted gross income (modified AGI) plus half of the social security benefits. Modified AGI is AGI before any inclusion of taxable social security benefits, plus tax exempt interest income and amounts excluded from gross income under IRC Sec. 135 (interest from Series EE and I bonds used to pay college expenses), IRC Sec. 137 (employer-provided adoption assistance), IRC Sec. 911 (foreign earned income and housing costs exclusion), IRC Sec. 931 (income from certain U.S. possessions), and IRC Sec. 933 (income from Puerto Rico). In addition, the Section 221 deduction for student loan interest, the Section 222 deduction for qualified tuition and related expenses, and the Section 199 deduction for domestic producers are added back in computing modified AGI.

None of the taxpayer's social security benefits are included in income if provisional income does not exceed the following base amounts:

1. $25,000, if single, head of household, qualifying widow, or married but filing a separate return and the taxpayer did not live with spouse at any time during the year.
2. $32,000, if married filing a joint return.
3. Zero, if married but filing a separate return and the taxpayer lived with spouse at any time during the year.

Up to 50% of social security benefits are included in gross income when the taxpayer's provisional income exceeds the previous base amounts but is less than the adjusted base amounts. Up to 85% of social security benefits are included in income if provisional income exceeds the adjusted base amounts. The adjusted base amounts are as follows:

1. $34,000, if single, head of household, qualifying widow, or married but filing a separate return and the taxpayer did not live with spouse at any time during the year.

2. $44,000, if married filing a joint return.

3. Zero, if married but filing a separate return and the taxpayer lived with spouse at any time during the year.

Social security recipients can request that income tax be withheld from their benefit payments. Withholding is voluntary and can be initiated by completing IRS Form W-4V (Voluntary Withholding Request), requesting to have 7%, 10%, 15%, or 25% withheld for federal income tax, and submitting the form to the recipient's local social security office.

Lump-sum Social Security Payments

Generally, a lump-sum (or retroactive) payment of social security benefits (shown on either Form SSA-1099 or Form RRB-1099) is included in the taxpayer's total benefits in the year received. However, if some or all of the payment pertains to a prior year, the taxpayer can elect to determine the taxability of such benefits based on the prior year's income and laws in effect for that year. Any benefits taxable under this election are added to current-year taxable benefits and included in the current year's return.

There are two methods to calculate the taxable part of the total benefits received:

1. **Regular Method.** Use current-year income to figure the taxable part of the total benefits (including those from a prior year) received in the current year.

2. **Lump-sum Election Method:**

    a. Refigure the taxable part of benefits for each prior year using that year's income, any benefits paid during that year, and benefits paid during the current year designated for that year.

    b. Subtract any taxable benefits for the refigured year that were previously reported. The remainder is the taxable part of the lump-sum payment.

    c. Refigure current-year taxable benefits without the lump-sum payment.

    d. Add all prior-year taxable benefits to current-year taxable benefits. Compare to taxable benefits calculated using the regular method and use the method that allows the lower taxable benefits.

IRS Pub. 915 contains worksheets for computing the taxable benefits using the lump-sum election method. To report benefits using the lump-sum election method, enter "LSE" on Form 1040 to the left of line 20a.

Repayment of Social Security Benefits

Taxpayers receiving social security benefits before they reach full benefit retirement (FBR) age are subject to limits on the amount of earned income they can have. This limit, if exceeded, can reduce the amount of their benefits.

When benefits are reduced because of excess earnings, taxpayers sometimes have to repay amounts they previously received. When this occurs, the amount of current year benefits subject to tax is reduced for the repaid amounts. However, benefits received in one year cannot be reduced by repayments in a later year when computing the taxable amount for the year they were originally received, even though the amount of the repayment cannot be determined until after year end (*Zavatto*). Thus, taxpayers might pay tax on social security benefits that they subsequently must repay because of excess earnings.

If repayments made during the year exceed the taxpayer's total benefits for the year and the repayments were for benefits previously included in gross income, the excess is treated as a repayment of income received in an earlier year under a claim of right. If the excess is $3,000 or less, it is a miscellaneous itemized deduction subject to the 2% of AGI floor. If it is over $3,000, special more favorable rules apply.

IRA Deduction and Taxable Social Security

A special computation is required when a taxpayer receives social security benefits, makes an IRA contribution, and is subject to the IRA phase-out as an active participant in an employer sponsored pension plan. The calculation is as follows:

1. Compute taxable social security as if no IRA deduction is taken,
2. Compute the IRA deduction allowed using the taxable social security figure from (1),
3. Recompute taxable social security for income tax purposes using the IRA deduction allowed from (2).

If a taxpayer takes the foreign earned income exclusion, foreign housing exclusion, U.S. possessions income exclusion, exclusion of income from Puerto Rico, or the exclusion of employer-paid adoption expenses, use worksheets in IRS Pub. 590, Appendix B.

This interplay of computing taxable social security and the IRA deduction phase-out most frequently will occur in a joint return where one spouse has earned income and is a participant in a retirement plan, while the other spouse is retired and receiving social security benefits.

Distributions of Nondeductible Contributions to Traditional IRAs

A taxpayer who makes nondeductible contributions to a traditional (versus Roth) IRA acquires tax basis in the IRA. Therefore, a portion of the distributions will be a nontaxable return of basis. Unfortunately, the taxpayer is not allowed to withdraw the nondeductible portion (basis) before withdrawing amounts includable as taxable income. Accordingly, each distribution will have both a nontaxable and a taxable component.

The nontaxable portion of current-year traditional IRA distributions is calculated as follows:

$$\frac{\text{Total nondeductible contributions}}{\text{IRA account balance at year end}} \times \text{IRA Distributions} = \text{Nontaxable portion of IRA distributions}$$

+ Amount distributed during year

+ Outstanding rollover[a]

[a] Outstanding rollover means any amounts distributed before year-end but rolled into another IRA in the following year under the 60-day rollover rule.

When calculating the amount of nontaxable distributions, the total fair market value (FMV) of all the individual's traditional IRAs (including SEP IRAs, SIMPLE IRAs, and IRAs containing funds rolled over from a qualified plan, but not Roth IRAs) must be included in the fraction's denominator. The taxpayer cannot use only the IRA from which the distributions were received. The FMV of all IRAs at year-end includes both realized and unrealized appreciation of IRA assets.

Example: Calculating nontaxable portion of IRA distributions.

Tommy, age 60, has two traditional IRAs, one at National Bank and the other at State Bank. He has made $3,000 of contributions (all were deductible) to the National Bank IRA and $5,000 (none were deductible) to the State Bank IRA. During 2011, he took a $4,000 distribution from the State Bank IRA. As of December 31, 2011, the FMV of the National Bank IRA was $9,000 and the FMV of the State Bank IRA was $3,000 (after reduction by his $4,000 distribution). What is the nontaxable portion of Tommy's 2011 distribution?

Although all of Tommy's 2011 distribution was from the State Bank IRA (to which only nondeductible contributions were made), both traditional IRAs must be included in the calculation. Thus, the nontaxable portion of his distribution is calculated as follows:

$$\frac{\$5{,}000}{\$9{,}000 + \$3{,}000 + \$4{,}000} \times \$4{,}000 = \$1{,}250$$

Accordingly, $1,250 of the distribution is a tax-free return of basis; the remaining $2,750 is taxable income. Part 1 of Form 8606 (Nondeductible IRAs) is completed to show the taxable amount of Tommy's distribution.

If Tommy's distribution came from the National Bank IRA, the results would be the same (assuming the combined value of the IRAs does not change). If a taxpayer has at least one traditional IRA with tax basis, distributions from traditional IRAs will include a return of basis, regardless of which traditional IRA they came from.

A taxpayer recognizes a loss in the year an IRA is liquidated if the account's basis exceeds the value of the liquidating distribution. The liquidating distribution should be reported on line 15a of Form 1040. The taxable amount reported on line 15b is zero. Per IRS Pub. 590, the deductible loss (excess of tax basis over liquidating distribution) should be reported on Schedule A as an itemized deduction subject to the 2%-of-AGI floor. Loss can be recognized only when *all* amounts in *all* of the taxpayer's traditional IRAs have been distributed, and total liquidating distributions are less than the total basis in the accounts. Also, the loss is not deductible for AMT purposes.

Distributions from Roth IRAs

A Roth IRA is simply an IRA designated as a Roth IRA when it is opened. Taxpayers make nondeductible contributions to Roth IRAs and, if certain conditions are met, receive tax-free distributions. Except as provided by IRC Sec. 408A, all the rules that apply to traditional IRAs apply to Roth IRAs.

Required distribution rules do not apply to the owner of the account. Beneficiaries, however, are subject to the RMD rules.

A distribution from a Roth IRA is not taxable if it is:

1. A qualified distribution (defined below);
2. A return of the owner's original Roth IRA contributions; or
3. Rolled over to another Roth IRA.

A **qualified** distribution is a distribution that is made after a five-taxable year period (see definition below) **and** at least one of the following:

1. Made on or after the date the owner attains age 59½;
2. Made to a beneficiary or the estate of the owner on or after the date of the owner's death;
3. Attributable to the owner's being disabled; or,
4. Used under the first-time home purchase provision.

The five-year taxable period:

1. Begins on the first day of the tax year for which the first regular contribution is made to any Roth IRA, or, if earlier, the first day of the year of the first conversion contribution (i.e., rollover from a traditional IRA); and
2. Ends on the last day of the individual's fifth consecutive tax year.

Any nonqualified distributions that exceed the owner's contributions to all of his/her Roth IRAs are taxable. The 10% penalty tax under IRC Sec. 72(t) will apply (unless an exception is met) to any distribution from a Roth IRA that is includible in gross income.

The 10% penalty tax applies to a nonqualified distribution, even if it is not includible in gross income in the year of distribution, to the extent it is allocable to a conversion contribution, if the distribution is made within the five-taxable-year period beginning with the first day of the individual's taxable year in which the conversion contribution was made. The exceptions under IRC Sec. 72(t) also apply to such a distribution (five years or 59½, etc.).

The five-taxable year period is separately determined for each conversion contribution, and need not be the same as the five-taxable-year period used to determine whether a distribution is qualified or not.

The beginning of the five-taxable-year period is not recalculated when the Roth IRA owner dies.

A decedent's holding period applies to both beneficiary and surviving spouse who treat the decedent's Roth IRA as his/her own.

Ordering Rules

Distributions are determined as of the end of the taxable year and in the following order (each category is exhausted before moving on to the next category):

1. From regular contributions
2. From conversion contributions, on a FIFO basis
    a. Taxable portion first
    b. Nontaxable portion
3. From earnings

This ordering rule is very favorable to the taxpayer and differs from ordering rules that apply to traditional IRAs with nondeductible contributions.

Distributions treated from a particular conversion are treated as being made first from the portion, if any, that was includible in gross income.

Source of distributions are as follows:

1. All distributions from an individual's Roth IRAs are aggregated.
2. All regular contributions made for the same taxable year are aggregated and added to the undistributed total regular contributions for prior taxable years.
3. Recharacterization is treated as having occurred on the same date and for the same year as the original contribution.
4. The effect of income or loss occurring after contribution to the first IRA is disregarded in determining amounts recharacterized.

The following table is a summary of the Roth IRA withdrawal rules:

Type of Withdrawal	Subject to Income Tax?	Subject to 10% Penalty?
Contributions	No	No
Conversions	No	Yes – Unless Exception 1
Earnings	Yes – Unless Exception 2	Yes – Unless Exception 3

Exception 1: Five Years ***OR*** >59½, or deceased, or disabled, or first-time homebuyer.

Exception 2: Five Years ***AND*** >59½, or deceased, or disabled, or first-time homebuyer.

Exception 3: Five Years ***AND*** >59½, or deceased, disabled, first-time homebuyer, education, medical expenses, health insurance or periodic payments.

Roth IRA Miscellaneous Provisions

A loss can be claimed when all the amounts in **all** of the Roth IRA accounts have been distributed and the total distributions are less than the unrecovered basis.

1. Basis is the Roth contributions, less any previous nontaxable distributions and conversions.
2. This loss is then claimed as a miscellaneous itemized deduction, subject to the 2% limit, on Schedule A.

Distributions to a beneficiary that are not qualified distributions will be includible in the beneficiary's gross income.

An individual who is required to receive minimum distributions from a traditional IRA cannot choose to take the amount from a Roth IRA.

Property distributed from a Roth IRA is valued at its fair market value on the date of distribution.

Educational IRA amounts cannot be transferred to a Roth IRA.

Converting Traditional IRAs into Roth IRAs

If certain conditions are met, all or any part of a deductible or nondeductible traditional IRA balance can be rolled over (or converted) into a Roth IRA. Taxpayers recognize taxable income at the time of the conversion, but future benefits of the Roth IRA include nontaxable distributions, contributions that can continue past age 70½, and no age 70½ minimum distributions rules, among others.

Throughout this discussion, the terms rollover and conversion are used interchangeably. IRC Sec. 408A uses the term "rollover," but the practical effect of a rollover from a traditional IRA into a Roth IRA is a conversion of the traditional IRA into a Roth IRA.

Conversion Requirements

Taxpayers can convert a traditional IRA into a Roth IRA. The amount converted is subject to ordinary income tax but does not incur a 10% early distribution penalty provided the amount converted satisfies the definition of a qualified rollover.

The modified AGI (MAGI) limitation has been eliminated starting in 2010. No conversions are allowed for individuals filing married filing separate returns.

MAGI for Roth Conversion is calculated in the same manner as for a deductible IRA contribution except:

a. Any conversion amount is disregarded.
b. For years after December 31, 2004, MAGI does not include any required minimum distributions from traditional IRAs (including SEP and SIMPLE IRA). RMD from qualified plans are included in MAGI.

c. Solely for determining Roth conversion eligibility, above the line deductions ($25,000 passive rental losses) are recomputed to account for the exclusion of income resulting from the Roth Conversion.

For conversions done during 2010, the taxable amounts (and taxes paid) may be reported one-half in each 2011 and 2012 (IRC 408A, as amended by TIPRA). The taxpayer may **elect** to report the entire amount in 2010, the year of conversion.

Conversion may be accomplished by any of three methods:

1. A distribution from a traditional IRA is rolled over to a Roth IRA within 60 days.
2. An amount in a traditional IRA is transferred to a Roth IRA by means of a trustee-to-trustee transfer.
3. An amount in a traditional IRA is transferred to a Roth IRA maintained by the same trustee.

A conversion by an individual whose AGI exceeds the limitation creates a failed conversion.

Starting in 2008, rollovers from other qualified plans [e.g., 401(k), 403(b), 457, pension plan] can be converted directly to Roth IRA accounts. This eliminates the need to set up a regular IRA account to receive the qualified plan distribution.

Amounts in a SIMPLE can also be converted; however, they cannot be converted during the two-year penalty period (which begins the date the employee enters the plan) applied to premature distributions from a SIMPLE.

Required minimum distributions (RMD) cannot be converted to a Roth IRA. Prior to a conversion, the RMD must be taken.

The taxable conversion amount is included in income for all purposes (taxable social security, passive limits, and all other AGI-sensitive calculations) other than modified AGI in determining the Roth IRA contribution.

Conversion considerations:

1. Establish a separate Roth IRA account for the conversion. This will eliminate issues dealing with the calculation of income in cases where funds have to be recharacterized.
2. The taxpayer must meet the modified AGI limit in the year the funds are withdrawn from the traditional IRA and not the year that the conversion is completed. If the taxpayer meets the MAGI limitation in 2008, the fund must be withdrawn for the traditional IRA in 2008.
3. A SIMPLE IRA cannot be converted within the first two years of participation.
4. Consider the client’s need for IRA funds and their ability to pay the taxes resulting from the conversion.
5. Consider the impact on taxation on the client’s social security payments.

6. Not all IRA accounts need to be converted at one time. Convert funds over multiple years to take advantage of lower tax brackets.
7. Income with respect to the Decedent—Many beneficiaries are in higher tax brackets than the senior IRA owners. Conversion could yield a long-term tax savings.
8. Look for planning opportunities—NOLs and negative TI.
9. Consider converting low current value but high growth potential assets.
10. Review the beneficiary form—Conversion could be used as an estate planning tool to stretch the value of IRA by naming young beneficiaries with ultimately low RMD.
11. Reduce estate taxes—Pay out the associated income tax and reduce the IRD at the same time.
12. File the tax return on time.
13. Conversions withdrawn before a five-year period may be subject to the 10% penalty.

Reversing a Rollover or Conversion

A taxpayer who converts a traditional IRA to a Roth IRA can undo all or part of the conversion by doing a trustee-to-trustee transfer of the funds from the Roth IRA to a traditional IRA no later than the due date, including the six-month extension, for the return for the year the conversion originally occurred. (The IRS refers to this as a “recharacterization” of the contribution to the Roth IRA.) Recharacterizing the contribution no later than the extended due date of the return (generally October 15) is available regardless of whether the taxpayer actually extends his tax return, as long as the return is timely filed. The transfer to the traditional IRA is treated as if it were the original recipient of the rollover, so the tax consequences of the initial conversion to the Roth IRA are avoided (i.e., the taxpayer does not recognize the income that would have been recognized with the initial Roth conversion). The transfer must include the earnings allocable to the converted amount.

When less than the entire IRA is recharacterized, the earnings (or loss) attributable to the recharacterized amount is calculated by considering only the net income or loss that accrues during the period the Roth IRA actually holds the conversion contribution. The formula is as follows:

$$\text{Allocable Income or Loss} - \text{Contribution} \times \frac{\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance}}{\text{Adjusted Opening Balance}}$$

The *adjusted opening balance* is the FMV of the Roth IRA at the beginning of the computation period plus any contributions (including the conversion contribution) made during the computation period. The *adjusted closing balance* is the FMV of the Roth IRA at the end of the computation period plus any withdrawals taken from the IRA during the computation period. The *computation period* is the period beginning immediately before the contribution being recharacterized was made to the Roth IRA and ending immediately after that contribution is withdrawn.

Before reversing a conversion, an individual must notify the trustees of both IRAs involved in the recharacterization that he or she has elected to treat the contribution (rollover) as having been made to the second, instead of the first, IRA for income tax purposes. Taxpayers will receive several information returns when a conversion is recharacterized. Pursuant to

IRS Notice 2000-30, the trustee of the first IRA will report prior year recharacterizations on Form 1099-R, coded with Code R in Box 7, while same year recharacterizations will be coded with code, N, in Box 7. The trustee of the second IRA reports the gross amount received in a recharacterization (contributions plus earnings) on Form 5498. See IRS Notice 2000-30 for further guidance and examples. Taxpayers must attach a statement to their Form 1040 explaining the details of the recharacterization.

Taxpayers who fail to timely undo an erroneous IRA conversion can seek relief from the IRS under the provisions of Reg. 301.9100-3. In several cases, the IRS has granted taxpayers extensions of time to recharacterize an erroneous IRA conversion. For example, a taxpayer who made a Roth IRA conversion but discovered after filing her return for the year of the conversion that she was ineligible because her AGI was too high was granted a six month extension (from the date of the letter ruling) to recharacterize the conversion (Ltr. Ruls. 200116058 and 200116053). Similarly, a taxpayer whose IRA trustee failed to recharacterize the taxpayer's IRA as requested was granted relief by having the recharacterization deemed timely by the IRS. In granting relief, the IRS found that (1) the taxpayers acted reasonably and in good faith and (2) granting relief would not prejudice the interests of the government, as required by Reg. 301.9100-3.

In several letter rulings, the IRS has granted relief to taxpayers who had mistakenly made Roth IRA conversions but later learned they were ineligible to do so and attempted to re-characterize the conversion after the period allowed for reconversions had expired. Based on Regs. 301.9100-1 to 301.9100-3 the IRS has granted an extension of time to recharacterize the Roth IRA as a traditional IRA for a taxpayer misadvised by his accountant. A similar ruling provided relief to a taxpayer who received works of art, originally considered to be gifts. Later the value of the gifts was recharacterized as receipts of professional fees applicable to the conversion year. The additional income disqualified him for making a Roth IRA conversion in that year. Another ruling granted extension of time to recharacterize a Roth IRA as a traditional IRA where retroactive inclusion in income of imputed value of group-term life insurance barred Roth IRA ownership. However, an IRS Service Center Advice ruling (SCA 200148051) is not so taxpayer friendly. The advice requires that extra income uncovered on audit can invalidate a Roth conversion. It further clarifies that the IRS can impose the 6% penalty for an excess contribution to the Roth and a 10% levy for an early distribution if the taxpayer is under 59½ years old. This highlights the importance of seeking an extension to reconvert as soon as a taxpayer's modified AGI is found to exceed $100,000 for the year in which a conversion was made.

Number of Reconversions Limited. An individual who converts a traditional IRA to a Roth IRA, and then undoes the conversion, cannot then reconvert the traditional IRA to a Roth IRA until the later of the following:

1. The beginning of the tax year following the year of the original Roth conversion, or

2. The end of the 30-day period beginning on the day the original conversion was recharacterized (i.e., the day the Roth IRA was converted back to a traditional IRA).

Reconversions that are made outside of the timeframe outlined in the immediately preceding paragraph are treated as failed conversions. A failed conversion is treated as a taxable distribution from the traditional IRA [and possibly subject to the early withdrawal penalty tax unless one of the exceptions in IRC Sec. 72(t) applies] followed by a regular annual contribution to the Roth IRA. 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 6% excise tax of IRC Sec. 4973(a) [Regs. 1.408A-4, Q&A-1(d); 1.408A-4, Q&A-3(b); 1.408A-5, Q&A-9(a)(1)].

Simplified Methods for Taxing Annuity Payments from Qualified Plans

A qualified plan participant who makes nondeductible (or nonexcludable) contributions obtains a tax basis (or cost) in the plan. Technically, this basis is called the taxpayer's "investment in the contract." Because the taxpayer previously paid income taxes on his investment in the contract, the law provides a series of formulas for the participant to exclude from gross income a portion of his investment (basis) in the plan.

When a taxpayer makes nondeductible contributions to a qualified plan, a portion of each distribution received at retirement is considered a nontaxable return of basis. The tax-free portion of the distribution is figured using one of the following methods:

1. **Simplified Method.** For **annuities** starting after 1997, the following simplified method is available to calculate the tax-free portion of a distribution.

Simplified Method—Annuities Starting after 1997

1. Total investment in contract.. $_______
2. Number of expected payments.. _______
3. Divide line 1 by line 2.. _______

Line 1. Total after-tax contributions to the plan minus any nontaxable amount received before the annuity starting date.

Line 2. Total number of expected payments under the plan. Use the number from the following tables. If payments are based on the joint lives of the annuitant and account beneficiary, use the numbers from the Multiple Lives Annuity table (use youngest survivor annuitant if there is more than one).If the annuity does not depend on anyone's life expectancy, use the total number of monthly annuity payments under the contract.

Line 3. Nontaxable portion of each annuity payment received.

Single Life Annuity		**Multiple Lives Annuity**	
Age at annuity starting date	Line 2 Amount	Combined age at starting date	Line 2 amount
55 or under	360	110 and under	410
56–60	310	111–120	360
61–65	260	121–130	310
66–70	210	131–140	260
71 or older	160	141 and over	210

Different expected payment factors apply to annuities with start dates before 1998. See IRS Pub. 554 for the amounts.

2. **General Rule Required.** The so-called General Rule must be used to compute the tax-free part of each annuity payment for any of the following:
   - Nonqualified plans (such as nonqualified employee plans or commercial annuities),
   - Qualified plan if the annuitant is age 75 or older and if the annuity payments are guaranteed for at least five years, or
   - An individual retirement account or annuity.

Rolling over Qualified Retirement Plan and IRA Distributions

Rolling over Distributions from Qualified Retirement Plans

Taxpayers can transfer assets (money or property) from one eligible retirement plan to another tax-free in the following kinds of transfer:

- Trustee-to-trustee, or
- Rollover.

Eligible retirement plans:

- Traditional IRA;
- Qualified pension, profit-sharing or stock bonus plan [including SEPs and 401(k) plans];
- Section 457 government plan; and
- 403(b) plan.

Transfers to Roth IRAs. In some cases, retirement plan assets can be transferred to a Roth IRA, but tax must be paid on the transfer unless the transfer is from another Roth IRA.

Trustee-to-Trustee Transfers. Assets can be transferred directly from one traditional IRA trustee to another, either at the taxpayer's or the trustee's request. This is tax-free to the account owner. A trustee-to- trustee transfer is not reported on Form 1099-R. Likewise, SIMPLE IRA and SEP IRA assets can be transferred trustee-to-trustee to another SIMPLE IRA or SEP IRA, respectively.

A trustee-to-trustee transfer is not subject to the one-year waiting period that applies to rollovers to and from IRAs. Also, since the account owner never takes possession of the assets, there is no danger that the distribution will be taxed because it is not rolled into an eligible retirement plan within the required 60-day period.

Rollovers. A rollover occurs when a taxpayer receives a distribution of eligible retirement plan assets and within 60 days reinvests the assets in another eligible retirement plan. This transfer to the receiving plan is called a rollover contribution. Any portion of the distribution not rolled over within 60 days is taxed on the date it was received, not the 60th day after the withdrawal.

When a distribution from an employer's plan or IRA contains any property other than cash, either the property itself must be rolled over, or the property must be sold and the proceeds rolled over for the transaction to be tax-free. The taxpayer may not retain the property and substitute other funds (Rev. Rul. 87-77). If the property is sold and the proceeds rolled over, no gain or loss from the sale is recognized, and proceeds are not included in gross income.

Eligible Rollover Distributions. Any qualified plan or IRA distribution is eligible for rollover, except:

- Required minimum distributions.
- Distributions paid at least annually over life expectancy.
- Distributions paid as installments for at least 10 years.
- Return of excess contributions or deferrals under 401(k) plans.
- Imputed distributions of life insurance protection (P.S. 58 costs).
- Plan loans that are deemed to be distributions either upon origination or default.
- Distributions of employee stock ownership plan (ESOP) stock dividends made pursuant to Section 404(k).
- Hardship distributions from 401(k) and 403(b) plans.

Waiting Period between IRA Rollovers. Generally, if any part of a distribution from a traditional IRA is rolled over tax-free to another traditional IRA, taxpayers must wait one year before making another tax-free rollover from the distributing IRA. Also, within that one-year period, no distributions from the receiving IRA can be rolled over tax-free. The one-year period begins on the date the distribution is received, not the date it is rolled over into another IRA.

Exceptions to 60-day Rollover Rule. The IRS can waive the 60-day rollover period when the taxpayer's failure to meet the requirement was beyond his reasonable control (IRC Sec. 408(d)(3)(I)). Taxpayers must apply to the IRS for a waiver by following the general instructions used in requesting a letter ruling. A user fee ranging from $500 to $3,000 (depending on the amount of the rollover) must be paid with the application. (Rev. Proc. 2008-8)

The IRS will consider all relevant facts and circumstances, including:

- Whether errors were made by the financial institution;
- Whether the taxpayer was unable to complete the rollover due to death, disability, hospitalization, incarceration or restrictions imposed by a foreign country or postal error;
- Whether the taxpayer used the amount distributed (in the case of payment by check, whether the check was cashed); and
- How much time has passed since the date of distribution.

A letter ruling is not necessary if a financial institution receives the funds before the expiration of the 60-day rollover period, the taxpayer followed all procedures required to make the rollover, and, solely due to the financial institution's error, the funds were not deposited into an eligible retirement plan. (Rev. Proc. 2003-16)

Rollovers from an Employer's Plan to an IRA. The following rules apply when assets are rolled from an employer plan to an IRA:

- **No Waiting Period.** The once-a-year limit on IRA-to-IRA rollovers does not apply to eligible rollover distributions from an employer plan. Taxpayers can roll over more than one distribution from the same employer plan within a year.

- **Federal Withholding.** Employers must withhold 20% of an eligible rollover distribution (if over $200) made from qualified plans to the employee [IRC §3405(c)(1)]. Note that no withholding is required on IRA distributions. If the 20% withholding applies and the remaining funds are rolled over, the taxpayer may be subject to tax plus the 10% early withdrawal penalty on the portion that is withheld.

Example: Omar, age 45, has $50,000 in a qualified pension plan. His employer terminates the plan and distributes all of the plan assets. The employer withholds $10,000 for federal taxes and distributes $40,000 to Omar. Omar rolls the $40,000 into his IRA. The $10,000 not rolled over is subject to income tax plus the 10% early withdrawal penalty. To avoid the tax, Omar must come up with an additional $10,000 to roll into his IRA. All of this would be avoided if Omar had directed his employer to transfer the funds directly into his IRA.

Retirement Plan Rollover Chart

Roll From \ Roll To	IRA	SEP-IRA	SIMPLE IRA	Roth IRA	457(b)	403(b)	Employer Retirement Plan	Designated Roth Account
IRA	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes	No
SEP-IRA	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes	No
SIMPLE IRA	Yes, after two years.	Yes, after two years.	Yes	Yes, after two years. Must include in income.	Yes, after two years. Must have separate accounts.	Yes, after two years.	Yes, after two years.	No
Roth IRA	No	No	No	Yes	No	No	No	No
457(b)	Yes	Yes	No	Yes, must include in income.	Yes	Yes	Yes	No
403(b)	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes	No
Employer Retirement Plan	Yes	Yes	No	Yes, must include in income.	Yes, must have separate accounts.	Yes	Yes	No
Designated Roth Account	No	No	No	Yes	No	No	No	Yes, if a direct trustee-to-trustee transfer.

Note: Although permitted under the tax laws, some rollovers are subject to the particular terms of the plan.

Inherited Retirement Accounts

A surviving spouse can roll over the balance from a deceased spouse's eligible retirement plan into his own eligible retirement plan account. He can also elect to treat a deceased spouse's IRA as his own. In such a case, the IRA distribution rules are applied with the surviving spouse as the owner. These options are available whether the participant died before or after

minimum required distributions (MRDs) had begun. In Ltr. Rul. 200717021, a surviving spouse/ administratrix was allowed to roll over a decedent's (husband's) previously withdrawn IRA distributions to a new IRA established in the name of the decedent within sixty days of the withdrawal. However, since the decedent had not posthumously named the surviving spouse as a beneficiary of the newly established IRA, the surviving spouse was not eligible to treat the IRA as her own. A surviving spouse who neither rolls distributions over nor elects to treat the IRA as his own must take distributions from the account based on the MRD rules.

Ltr. Rul. 200110033 indicates that the surviving spouse can elect the roll over option even after receiving MRDs in more than one year. The ruling also stated that even though the surviving spouse was under age 59½ when the MRDs were received, the later election to roll over the IRA did not subject the distributions to the early distribution penalty. The IRA was treated as a continuation of the deceased spouse's IRA until the actual rollover was made. After the rollover, it was treated as the surviving spouse's IRA.

A surviving spouse must generally be named as the direct beneficiary of the account to qualify for rollover treatment. If the surviving spouse receives the distribution through the decedent's estate (i.e., the decedent named his estate as the beneficiary), the distribution may be treated as received from a third party. Generally, this prevents the surviving spouse from taking advantage of the special rollover provisions. However, the IRS has made some exceptions. For example, the IRS privately ruled that a surviving spouse who (1) was the named beneficiary for 75% of an IRA, (2) received the remaining 25% through the decedent's estate, and (3) was the sole executrix of the estate could treat the entire account as being received from the decedent with none from the estate. The same outcome was reached where the surviving spouse was the sole executrix and beneficiary of the decedent's residuary estate. The rollover must occur no later than the 60th day after the date of distribution to the estate.

For distributions after December 31, 2006, a favorable change included in the 2006 Pension Act allows a nonspouse beneficiary's IRA to receive a tax-free rollover of an eligible distribution from the decedent's qualified retirement plan. The rollover must be accomplished with a direct (trustee-to-trustee) transfer. Similarly, rollovers are allowed for amounts paid to a nonspouse beneficiary of a decedent's Section 403(a) annuity, Section 403(b) annuity, or governmental Section 457 plan. Once in the receiving IRA, the rolled-over amount will fall under the MRD rules that apply to inherited IRAs. Because MRDs must be taken with respect to rolled-over amounts (calculated under the rules for inherited IRAs), a new IRA should be established to receive the rollovers.

Rollovers to Nonspouse Beneficiaries. For plan years beginning after 2009, qualified retirement plans must allow nonspouse beneficiaries to make trustee-to-trustee rollovers to their IRAs, subject to the written explanation and mandatory 20% withholding requirements (Worker, Retiree, and Employer Recovery Act of 2008).

Invalid Rollovers

If a taxpayer makes an invalid rollover (i.e., a rollover not complying with the rules discussed in this section), an excess contribution results. An example of this is when a taxpayer rolls over a portion of a qualified plan distribution not eligible to be rolled over (such as a RMD). If the invalid rollover is from one IRA to another, part or all of the distribution (depending on whether the taxpayer has basis in the IRA) will be taxable and subject to the 10% premature distribution penalty, if applicable.

Excess IRA Contributions

A contribution (other than an eligible rollover contribution) that is more than the smaller of (a) compensation, or (b) $5,000 ($6,000 age 50 or older), is an excess contribution. A contribution made to a traditional IRA for the year the taxpayer reaches age 70½, or any later year, is also an excess contribution. There is a 6% excise tax each year on excess amounts remaining in the IRA. An excess contribution is reported on Form 5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

An excess contribution can be corrected as follows:

1. The 6% excise tax will not apply if the excess contribution plus the income earned on the excess amount is withdrawn by the due date, including extensions, of the tax return. The excess amount that is withdrawn is not included in taxable income. However, the income earned must be included in gross income (in the year the excess contribution was made), and may also be subject to the 10% tax on early withdrawals if the taxpayer is under age 59½.

2. If total IRA contributions for 2011 are $5,000 or less ($6,000 or less if age 50 or older), the excess amount can be withdrawn at any time and not be included in gross income provided it was not deducted. If a deduction was taken for the excess contribution, file Form 1040X to correct the deduction amount. The 6% excise tax will apply each year the excess contribution remains in the IRA.

   If total contributions exceed $5,000 in 2011 (or $6,000 if age 50 or older) and the excess is not withdrawn by the tax return due date, then the entire excess will be taxable when withdrawn even though no deduction was allowed for the excess contribution.

3. Excess contributions that cannot be deducted in the year of contribution can be added to the contributions in a later year, if the contributions for that later year are less than the maximum allowed for that year. This method avoids having to make a withdrawal but doesn't avoid the 6% excise tax on any excess contributions remaining at the end of the year.

Example: In 2011, Camilla contributed $1,500 to her IRA but was only entitled to contribute $1,200 due to her taxable compensation for the year. If she is entitled to deduct $5,000 in 2012, Camilla may correct her excess 2011 contribution by under-contributing $300 in 2012.

Her deduction for 2011 is $1,200, and her deduction limit for 2012 will be the lesser of compensation or $5,000 ($4,700 contribution plus 2011 excess carryover of $300). Camilla will still be liable for the 6% excise tax in 2011 on $300, the 2011 excess contribution.

Excess Due to Incorrect Rollover Information. If an excess contribution to a traditional IRA is the result of a rollover that occurred because the required information received from the distributing plan was incorrect, the excess contribution can be withdrawn. Do not include the excess contribution in gross income for the year the excess is withdrawn but rather amend the Form 1040 to correct the reporting for the year in which the excess occurred.

> **Example:** In 2011, Mary Beth received $200 from her deceased husband's former employer. The information provided with the distribution check indicated that the distribution was eligible to be rolled over to an IRA. Mary Beth had made the maximum IRA contribution earlier, but since this was supposedly eligible to be rolled over she contributed the $200 to her IRA. In 2012, she received information that the $200 was a special distribution that was not eligible for rollover. Since she had made the maximum contribution in 2011 the additional $200 became an excess contribution. To correct the problem Mary Beth should withdraw the $200 plus its earnings in 2012 and amend her 2011 Form 1040 to properly report the $200 and earnings in income. Since the excess contribution was caused by incorrect information, she can correct it without being subject to the excise tax for an excess contribution in 2011.

Divorce-related Transfers of Retirement Plan Assets

Qualified Retirement Plan Benefits

In marital dissolutions, one spouse's qualified retirement plan benefits are often used to fund marital property settlements to a spouse, former spouse, child, or other dependents (i.e., alternate payees) of the plan participant. Qualified plan benefits paid to a nonspousal alternate payee do not receive special tax treatment and are taxable to the employee-participant; however, amounts paid to a spouse or former spouse under a qualified domestic relations order (QDRO) receive special treatment. Essentially, the spouse or former spouse can treat the distribution the same as the employee-participant. Furthermore, such payments are taxable to the spouse or former spouse, not to the employee-participant.

A distribution made to the plan participant's spouse or former spouse can be partially or wholly rolled over tax free to the spouse's eligible retirement plan (i.e., qualified plan, traditional IRA, 403(b) plan, or governmental 457 plan) if it is done within 60 days of receipt and:

1. It is distributed to the recipient under a QDRO, and
2. It would have met the definition of an eligible rollover distribution if it had been made to the employee.

What Is a QDRO?

A QDRO is a court order that is used to assign the benefits of a qualified retirement plan to a nonemployee alternate payee. For this purpose, a domestic relations order is any judgment, decree, or order including approval of a property settlement agreement that:

1. Relates to the provision of child support, alimony payments, or marital property rights to spouses, former spouse, child, or other dependent of a participant; and
2. Is made under a state domestic relations law, including a property law.

A valid QDRO must clearly specify:

1. The name and last known mailing address of the participant and the name and mailing address of each alternate payee to be covered;

2. The amount or percentage of the participant's benefits to be paid by the plan to each alternate payee, or the manner of determining the amount or percentage;

3. The number of payments or period to which the order applies; and

4. Each plan to which the order applies.

A plan administrator is required to determine if an order meets QDRO requirements within a reasonable period of time after the receipt of the order and is to notify the spouses and any alternate payee of that determination.

The tax consequences of QDRO payments include:

1. The payments are taxed to the spouse or former spouse when received.

2. If the original participant contributed to the retirement plan, a pro-rated share of that participant's cost (investment in the contract) is used to figure the taxable amount.

3. Lump-sum distributions to a beneficiary may be eligible for special averaging or capital gain treatment if the original participant would have been eligible for that treatment.

4. All or part of the distribution qualifies for rollover to an IRA. The rollover must be completed within 60 days of receipt.

5. The 10% additional tax on premature distributions does not apply.

Nonqualified plans such as IRAs, deferred compensation plans, and annuities do not require a QDRO.

Model QDRO language can be found within IRS Notice 97-11.

Individual Retirement Accounts (IRAs):

1. Transfer of an IRA under a divorce decree is not a taxable transfer.

2. Starting from the date of the transfer, the receiving spouse is treated as the account's owner.

3. Alimony received constitutes earned income for purposes of computing the IRA contribution deduction limit.

Court Case: The settlement agreement required the husband to transfer his IRA to his former wife. The taxpayer, who was 47 years old, cashed out the IRA and endorsed the check over to his ex-wife. While a direct transfer of ownership would have been without tax consequences, the tax court held that cashing out the IRA was tantamount to a premature distribution subject to tax and the 10% early withdrawal penalty (*Jones v. Comm.*).

Distributions from a SIMPLE IRA Plan

Distributions from a SIMPLE IRA plan (reported to the taxpayer on Form 1099-R) generally are subject to IRA distribution rules, not qualified plan distribution rules. However, some special rules apply to SIMPLE IRAs that do not apply to other IRAs.

Two-year Period Rules

Special rollover and early distribution tax rules apply for distributions from SIMPLE IRAs made during the two-year period beginning on the day the employee first participates in any SIMPLE IRA plan maintained by the employer. An employee begins participating in a SIMPLE IRA plan on the day the employer first deposits contributions to the employee's SIMPLE IRA.

If an employee terminates employment and two years have expired since the employee first participated in the SIMPLE plan, the employee's SIMPLE IRA is treated as a regular IRA.

Rollovers. During this two-year period, distributions from the SIMPLE IRA can be rolled over tax-free only to another SIMPLE IRA. After the two-year period, distributions from the SIMPLE IRA can be rolled over to eligible retirement plans [i.e., traditional IRAs, qualified plans, 403(b) plans, or governmental 457 plans] or Roth IRAs or to another SIMPLE IRA. (Rollovers must be completed within 60 days of when the participant receives the distribution.) Rollovers to eligible retirement plans will generally be tax-free while rollovers to Roth IRAs will be treated as taxable conversions.

Early Distribution Tax. As with any IRA, early withdrawals (i.e., distributions before age 59½) from a SIMPLE IRA generally are subject to the 10% early distributions tax unless a specific exemption applies. However, during the two-year period defined earlier, the early distribution tax for a SIMPLE IRA is 25% (rather than the standard 10%).

Required Minimum Distribution Rules for Retirement Accounts

Retirement accounts must be distributed beginning no later than the required beginning date (RBD) over the life of the participant or joint lives of the participant and designated beneficiaries.

Two sets of rules exist and apply. Separate calculations must be made for:

1. Lifetime distributions rules, which apply to the owners of the accounts, and
2. Beneficiary Rules, which deal with distributions required for inherited funds.

The RMD is calculated separately for each qualified plan and IRA.

The RMD from a qualified plan must come from the qualified plan.

The RMD from 403(b) can be combined and come out of any 403(b).

The RMD for all IRAs can be combined and come out of any IRA. SEP and SIMPLE IRAs are treated as IRAs for this purpose. Exception – IRAs held by the owner cannot be aggregated with IRAs held as beneficiary of another person; same rule for 403(b) plans held by the employee and 403(b) plans held as beneficiary.

Taxpayers who fail to comply with the minimum distribution rules are subject to a 50% penalty.

Participants and the Required Minimum Distributions

These rules apply to all stock bonus, pension, profit-sharing plans, 403(b) plans, deferred compensation plans, traditional IRAs. The owner's Roth IRA accounts are not subject to the lifetime distribution rules. All inherited accounts (including Roths) are subject to a separate set of rules.

Benefits must be distributed or start being distributed by the Required Beginning Date (RBD).

Required Beginning Date (RBD) for lifetime distributions is:

1. The later of April 1 of the calendar year following the year in which the participant reaches age 70½.

2. For retirement plan participants who are not more-than 5% owners in the employer, the required beginning date with regard to the plan assets is the later of April 1 following the year the employee reaches 70½ or retires from the employer.

3. A 5% or more owner of a business must start taking distributions no later than April 1 of the year following the calendar year owner reaches age 70½.

4. If the distribution is delayed until April 1 of the following year, there will be two distributions in that year. The account balance is not reduced by the prior-year calculated distribution.

5. The participant attains age 70½ six calendar months after the anniversary of the employee's birth.

6. If the participant's birthday is after June 30, age 70½ will not be reached until the next calendar year and April 1 (the RBD) will fall in the subsequent calendar year.

Example: Ron was born on August 1, 1940. Ron will reach age 70½ on February 1, 2011, and the RBD will be April 1, 2012.

Tax Planning Opportunity: If the IRA owner is still employed, is not a 5% owner and is participating in the employer's qualified plan, the employee might consider rolling over IRA assets into the employer plan. Assuming the plan will accept such rollovers, this action will delay RMD on the IRA assets until the participant retires. While this can delay the RMD, it can also have an adverse effect on nonspouse beneficiary's ability to take distributions over their lifetime.

The **first** distribution year is the calendar year in which the participant attains age 70½ **or** retires:

- If the employer's plan requires distributions at age 70½ even if the participant has not retired, the distributions can be rolled over into an IRA.

- If the participant misses a RMD in the year required, the corrective action is to take the RMD in the current year and calculate the current year's RMD using an account balance reduced by the missed RMD.

The Required Minimum Distribution (Life expectancy payout method) is computed as follows:

1. Calculate the account balance as of December 31 of the preceding year. This is similar to a cash reconciliation since outstanding amounts in transit must be accounted for.

    a. Includes contributions added (not allocated) and excludes distributions made during the calendar year.

    b. Includes rollovers made from another plan or IRA if the distribution was made in the prior calendar year and not completed until the current calendar year.

    c. Includes recharacterized contributions.

Example: Willie's only retirement account is his 401(k). He finally retired at age 83 in 2011 and rolled the entire 401(k) into an IRA. His first RMD is not until 2012. The RMD is calculated on the balance of the IRA as of December 31 of the year prior to his retirement. In this case, he did not have an IRA balance as of December 31, 2010, so no distribution is required in 2011.

2. Divide the account balance by the appropriate life expectancy factor using the age the participant will attain on his birthday in the applicable distribution year,

    a. For married individuals whose spouse is sole beneficiary and is more than 10 years younger than participant use the joint and last survivor tables.

        1) This is beneficial as it calculates a lower RMD. Verify the spouse is the sole beneficiary to avoid failing to meet the RMD.

        2) If the designated beneficiary is changed to anyone other than spouse, this table cannot be used (age-exception rule would no longer apply).

    b. In all other instances use the Uniform Lifetime Table.

3. If the account value has decreased below the calculated minimum based on the December 31 balance, the account can be depleted with no 50% penalty for not taking the full required distribution.

Beneficiaries and the RMD

The minimum distribution depends on the decedent's age and if the beneficiary is a designated beneficiary. Designated beneficiaries can be:

- Individual
- Group of individuals or
- See-through trust (see trusts named as beneficiaries).

Death of Owner Prior to RBD. If the owner dies prior to RBD and the spouse is the beneficiary, he or she can roll over the inherited amount and treat as own; or begin distributions the year the owner would have reached age 70½.

If the spouse elects to treat the retirement account as his/ her own, the account no longer qualifies for exception from the 10% penalty by reason of death. This could be potentially costly to the younger spouse that needs access to the funds and does not meet any of the other penalty exceptions.

For other beneficiaries, required distributions begin (at the earliest) in the calendar year following the year of the employee's death:

- If the designated beneficiary is an individual (such as the participant's child), RMD will be based on the beneficiary's life expectancy (Single Life Table).
- A qualifying trust may take RMD over a period not longer than the life expectancy of the oldest beneficiary.
- If there is no designated beneficiary, the entire account must be distributed by the end of the fifth year (five-year rule) following the year of the employee's death. This includes beneficiaries (one or more) that are not individuals (e.g., estate or charitable organization). No distributions are required before the fifth year.

Death of Owner *after* RBD. If the spouse is the beneficiary, the account balance can be rolled over and treated as the spouse's own account.

Nonspouse beneficiaries must take distributions over their life expectancy using the Single Life Table. If the designated beneficiary is older than the participant, the designated beneficiary can use the participant's remaining life expectancy.

RMD in the year of the participant's death must be made by the beneficiaries or prior to a rollover by the spouse if not made by the decedent.

If there is **no designated beneficiary**, RMD is taken over the life expectancy of the participant determined in the year of death, reduced by one year for each subsequent year after death.

Designated Beneficiaries. An estate is not a designated beneficiary. If the estate is the beneficiary and the spouse is the sole executor and sole residuary beneficiary of the estate, the spouse may roll over an IRA.

Designated beneficiaries are named by the participant or specified as an individual in the terms of the plan (e.g., "the employee's surviving spouse").

A designated beneficiary must be a named beneficiary as of the date of death—beneficiaries cannot be added or replaced even if named in the will.

Beneficiaries can be eliminated for purposes of determining who is "designated" by:

1. Disclaimer by notifying the custodian within nine months after the participant's death; or
2. By distributing their share to them.

Disclaimers can be used to "stretch" IRAs. An example would be if a primary beneficiary disclaimed as a designated beneficiary and allowed an IRA to pass to a much younger contingent beneficiary.

Designated beneficiaries will be those beneficiaries who remain (have not disclaimed or been eliminated) beneficiaries as of **September 30** of the year following the year of death.

During the period between the date of the participant's death and designation date of beneficiaries, if a beneficiary dies, required distributions are calculated using the life expectancy of the beneficiary (as if designated).

Beneficiaries that receive a distribution in the year of death are eligible to disclaim. They may disclaim by September 30 in the year following death even if they have received a distribution in the year of the decedent's death.

Encourage clients to name contingent beneficiaries. Typically, a spouse is named as the primary beneficiary with no contingent beneficiaries listed. Naming contingent beneficiaries allows for the continuation of the stretch in cases where the beneficiary spouse predeceases or dies shortly after the account owner.

Multiple Beneficiaries and Separate Accounts. If more than one beneficiary is designated and all beneficiaries are individuals, required distributions are based on the age of the oldest beneficiary.

Separate accounts can be established for each beneficiary at any time. **However**, for each beneficiary to be able to use his/her own life expectancy to calculate distributions, the separate accounts must be established by December 31 of the year following the year of the participant's death. Post-death investment gains and losses are allocated to the separate accounts on a pro rata basis.

Pecuniary gifts (specific dollar amounts or units to beneficiaries) that do not share in investment gains and losses after death do not qualify as separate accounts.

If separate accounts are not created and beneficiaries that are not individuals are included (e.g., a charity), the account will be subject to the five-year rule (completely withdrawn by the end of the fifth year following the year of death of the owner).

The beneficiaries of a trust can be considered designated beneficiaries and allowed to use the life expectancy method if **all** of the following requirements are met:

1. Trust is valid under state law;

2. Trust is irrevocable upon death of participant (e.g., living trusts);

3. Beneficiaries must be identifiable from the trust document and must be individuals. The life expectancy of the oldest beneficiary will be used to calculate RMD after the participant's death.

    a. A beneficiary can be disregarded in determining the oldest beneficiary if the individual is a successor to the interest of another beneficiary.

    b. If the spouse is the sole beneficiary of the trust, the spouse cannot roll over the account into his/her own IRA account.

    c. Separate accounts for beneficiaries cannot be created for RMD unless the trust is to be immediately divided into separate trusts after the participant's death.

4. Provide documentation to the plan administrator by October 31 of the year following the year of the participant's death. Such documentation would include a list of all beneficiaries of the trust as of September 30 of the year following the year of the participant's death or a copy of the actual trust.
5. Trustees and custodians are required to report if a minimum distribution is required in a calendar year for an IRA. Form 5498 will be used.

In a private letter ruling (PLR 2008811028), the IRS allowed some wiggle room for beneficiaries who failed to take distributions from the deceased taxpayer's account in a timely manner. Normally this would trigger the five-year rule requiring **all** funds be distributed within five years from the date of death.

1. The beneficiary of a deceased taxpayer's IRA failed to take distributions for three years following the participant's death.
2. Corrective distributions were taken and penalty excise taxes were paid for the three years. The beneficiary took a distribution representing the missing three year's RMD as well as the current year's RMD all in year 4.
3. A PLR was filed begging for forgiveness. The failure seemed to place the taxpayer in the position of having to take the balance of the account in five years, but the IRS approved the ability to take future withdrawals based on the beneficiary's life expectancy of 53 years.

Distributions from Commercial Variable Annuities

Individuals often purchase commercial annuities to provide or supplement retirement savings. These annuity contracts are between the individual and the issuer (typically an insurance company but often associated with and marketed through mutual fund companies) and are not related to a qualified retirement plan. Although these commercial annuities are not qualified plans, they still receive preferential tax treatment in that the earnings accumulate tax-deferred and are not taxable until withdrawn.

Deferred annuities can be either fixed or variable, depending on the owner's investment preferences. Fixed annuities generally pay a fixed interest rate while variable annuities generally allow the owner to select from among various investment options, including equity investments. Many variable annuities invest in stock and bond mutual funds, thus making them essentially a mutual fund investment with an insurance wrapper that allows the deferral of recognizing income until funds are withdrawn.

Note: The earnings are currently taxable to the taxpayer if he is considered the owner of the assets that fund the annuity contract. This will not happen as long as the taxpayer does not possess sufficient incidents of ownership over the sub-account assets, which generally requires that he (1) cannot select or direct the particular investments to be made by the investment funds, (2) cannot sell, buy, or exchange assets held in a particular investment fund, and (3) has no involvement in a particular fund's investment decisions.

This section focuses on the tax consequences of withdrawing funds from a deferred variable annuity. These are annuities that include investment options that produce variable, rather than fixed, returns during both the accumulation period and the annuitization period. Thus, the total return depends on the performance of the selected investments and cannot be predicted with any certainty.

General Tax Considerations

Income from variable annuity payments is treated as ordinary income under IRC Sec. 72. Despite the fact that an annuity may invest in stock mutual funds that generate capital gain income, all distributions from the annuity are taxed as ordinary income. Variable annuities are not subject to the mandatory distribution rules beginning at age 70½; however, many annuity contracts require the owner to begin annuity payments by a certain age, such as 80 or 85. Distributions before age 59½ may be subject to a 10% premature distribution penalty—see discussion later in this chapter.

Distributions from variable annuities can be either annuity payments or nonannuity payments. Annuity payments are those that (1) are received on or after an annuity starting date, (2) are payable in regular periodic intervals (e.g., monthly, quarterly, etc.), and (3) either the total is determinable at the starting date (fixed annuities) or the payments will be made over a definite or determinable time, such as single or joint life expectancy or term certain (variable annuities). Nonannuity payments are those distributions that are not part of the annuity payout. Different tax rules apply depending on the type of distribution.

Taxation of Annuity Payments

Annuity payments from variable annuities may fluctuate based on the performance of the underlying investments. However, Regs. 1.72-2(b)(3) and 4(d)(3) provide that the taxpayer's nontaxable return of investment portion of each payment is constant over the term and determined by dividing the investment in the contract (as adjusted for any refund feature) by the number of expected periodic payments. The portion of each payment that exceeds this amount is taxable ordinary income. Once basis has been completely recovered, any additional payments are fully taxable. An individual who surrenders a refund annuity in exchange for a cash payment that is less than the contract's basis recognizes an ordinary loss. If an individual has an annuity starting date after July 1, 1986, and dies without a surviving annuitant and before recovering all of the investment in the contract (basis), any unrecovered amount is deductible in the year of death.

If annuity payments for a prior year were less than the recovery of basis amount, the taxpayer can elect to recompute the exclusion amount for the current and future tax years. If the election is made, the unabsorbed excludable amount is spread over the remainder of the term of the payments.

Example: Computing taxable amount of variable annuity payment.

Ralph Redman purchased a variable annuity for $150,000 in 2005. On January 1, 2011, when he is 65 years old, Ralph begins taking annuity payments based on his life expectancy. The value of the contract at that time is $200,000. In 2011, Ralph receives $10,500. How much of the payment is taxable?

To determine the nontaxable amount each year, Ralph's investment in the contract is divided by the number of expected periodic payments. The single life expectancy for a 65-year-old person is 20.0 years, according to Table V of Reg. 1.72-9. Thus, the nontaxable amount of Ralph's 2011 payment is $7,500 ($150,000 ÷ 20 years). Ralph must include $3,000 ($10,500 – $7,500) in ordinary income in 2011.

Example: Computing taxable amount of variable annuity payment (continued).

Variation: Assume that in 2011, the value of Ralph's annuity investments dramatically decline. Because the amount he receives varies based on the value of the contract, his payment for 2011 only amounts to $6,000. This is less than his annual $7,500 basis recovery amount. Thus, none of the $6,000 received in 2011 is taxable.

Further assume that the annuity investments recover in value and in 2012 he receives $10,000. His nontaxable amount for 2012 is still $7,500. However, because his 2011 payment was less than his excludable amount, Ralph can elect to recompute his excludable amount for the remainder of the annuity payout period. To compute the new nontaxable recovery of basis amount, the unabsorbed amount from 2011 is allocated to the remainder of the recovery period based on Ralph's life expectancy in 2012. Ralph is 67 years old in 2012, and the life expectancy for a 67-year-old person is 18.4 years. Thus, the allocable amount of the $1,500 unabsorbed amount from 2011 to each remaining year is $82 ($1,500 ÷ 18.4). Beginning in 2012, Ralph's recomputed nontaxable amount each year is therefore $7,582 ($7,500 + $82). Of the $10,000 payment received in 2012, Ralph reports $2,418 ($10,000 – $7,582) as ordinary income.

The purpose of this provision is to prevent contract owners from purchasing multiple contracts during the same calendar year from a single issuer and making a substantial withdrawal from just one of those contracts to extract the income from that contract and then obtain nontaxable return of the investment in that particular contract. Instead, the aggregation rule will result in the income from all contracts bought that year from the same company being taxed before there is any nontaxable return of investment from any of those contracts.

Example: Aggregating annuity contracts issued in one calendar year.

Brenda, age 50, purchased five annuity contracts from the First State Life Insurance Company in 2008. Her initial investment in each contract was $50,000. On October 1, 2011, the contracts have each earned $12,000 and are valued at $62,000. Brenda withdraws $36,000 from one of the contracts on October 1, 2011. When aggregated, the income earned in all five of Brenda's contracts on October 1, 2011 totals $60,000 ($12,000 × 5). Therefore, all of her $36,000 withdrawal is considered to be income subject to taxation and the 10% penalty (assuming none of the exceptions to the penalty are available). Aggregation of the five contracts has prevented Brenda from recognizing only $12,000 of income and the remaining $24,000 as a return of her investment from the individual annuity that was the source of her withdrawal.

Variation: Assume the same facts, except one of the annuities has a value of $42,000 on October 1, 2011 indicating the contract has lost $8,000 since it was purchased. If Brenda makes her $36,000 withdrawal for this annuity (the contract with a loss of $8,000) the entire amount is still subject to taxation and the 10% penalty because of the aggregation rule since accumulated earnings of all five contracts is $40,000 (4 × $12,000 – 1 × $8,000), exceeding the $36,000 withdrawal.

If the annuity showing the $8,000 loss was the only contract Brenda purchased in 2008, the $36,000 withdrawal would be characterized as a combination of a $30,240 nontaxable investment being returned and a $5,760 loss treated as an itemized deduction not subject to the 2% AGI limitation for 2011.

Taxation of Nonannuity Payments

Distributions from a variable annuity that are not part of an annuity payout of the contract and that are received before an annuity starting date are taxed as ordinary income to the extent such payments do not exceed the undistributed income or earnings on the contract. Basis (or investment in the contract) is not allocated to nonannuity payments until all income has been distributed.

Thus, nonannuity payments are treated first as a distribution of income and then as a distribution of basis.

A special exception applies to annuities when the contract was issued before August 14, 1982. For these contracts, nonannuity payments are treated first as a return of basis (investment) before being taxed as income distributions. When an annuity contract includes investments both before August 14, 1982, and after August 13, 1982, nonannuity payments are first allocated to pre-August 14, 1982 basis, next to income related to such basis, and finally to the post-August 13, 1982 investment.

Contracts with pre-August 14, 1982 investment retain such character when exchanged for a new contract in a tax-free Section 1035 exchange. Thus, an annuity need not be the original contract with the original issuer to qualify under the pre-August 14, 1982 rule. Practitioners with clients who take nonannuity payments should inquire as to the history of the contract to ensure the payments receive the proper tax treatment.

Example: Computing the taxable amount of nonannuity payment.

In 2000, Ann purchased a variable annuity contract for $50,000. In 2011, when the value of the contract was $90,000, Ann withdrew $10,000 to help pay for a new swimming pool. She was age 55 at the time. She had not made any previous withdrawals and did not annuitize the contract. The 2011 withdrawal is a nonannuity payment. How is the withdrawal taxed?

Because the withdrawal is a nonannuity payment, no basis is allocated until all earnings on the contract have been withdrawn. Thus, Ann must report the entire $10,000 as ordinary income in 2011, because it is less than the $40,000 ($90,000 – $50,000) of total undistributed earnings on the contract. It is also subject to the 10% premature distribution penalty tax discussed later in this section.

An amount received for a full refund, surrender, redemption, or maturity of a contract is taxed as ordinary income to the extent the amount exceeds the individual's unrecovered investment in the contract.

Premature Distributions

IRC Sec. 72(q) imposes a 10% early distribution penalty on the taxable portion of payments received from annuity contracts before age 59½. The penalty does not apply to payments:

1. Made on account of the owner's death or disability.
2. That are part of a series of substantially equal periodic payments.
3. That are allocable to pre-August 14, 1982 investment in the contract.
4. That are allocable to any investment in the contract made 10 or more years before the distribution if the contract was issued before January 19, 1985.

Chapter 5 Exercises

Question 1: Retirement income and distributions.

Part 1: Where is the amount in Box 1 of the 1099-R reported on the Form 1040?

Part 2: Where is the amount in Box 2a of the 1099-R reported on the Form 1040?

Question 2: Repayment of social security benefits after year-end.

Allen began receiving social security benefits in 2011 at age 62 even though he continued to work part-time. He received $8,000 of benefits in 2011. In early 2012, Allen submitted to the Social Security Administration information concerning his 2011 earnings and because he exceeded the allowable amount of earned income, he was told he must repay $3,000 of his 2011 benefits. He did this in 2012. He received $12,000 of benefits in 2012.

How much social security must Allen include when computing the 2011 and 2012 taxable social security amounts?

Question 3: Withdrawal of principal from a Roth IRA.

Jamie was age 50 when he set up two Roth IRA accounts in 2010. He contributed $1,000 to each account that year and $1,000 to each in 2011 and 2012, so he made total contributions to each account of $3,000. On July 10, 2012, he had $4,500 in Account One and $4,000 in Account Two. He withdrew all $4,500 from Account One. How much of the withdrawal was taxable?

Question 4: Tax treatment of SIMPLE IRA distributions.

Antwan Patton, age 28, entered his employer's SIMPLE IRA plan on January 1, 2011. His employer made the first deposit into his SIMPLE IRA on January 15, 2011. Antwan quits on March 15, 2012, when he has $8,000 in his SIMPLE IRA. If he withdraws the $8,000, how can he avoid income tax and the penalty for early withdrawal?

Chapter 5 Exercise Solutions

Question 1: Retirement income and distributions.

Part 1: Where is the amount in Box 1 of the 1099-R reported on the Form 1040?

Answer: *1040 Page 1 Line 15a or 16a*

Part 2: Where is the amount in Box 2a of the 1099-R reported on the Form 1040?

Answer: *1040 Page 1 Line 15b or 16b.*

Question 2: Repayment of social security benefits after year-end.

Allen began receiving social security benefits in 2011 at age 62 even though he continued to work part-time. He received $8,000 of benefits in 2011. In early 2012, Allen submitted to the Social Security Administration information concerning his 2011 earnings and because he exceeded the allowable amount of earned income, he was told he must repay $3,000 of his 2011 benefits. He did this in 2012. He received $12,000 of benefits in 2012.

How much social security must Allen include when computing the 2011 and 2012 taxable social security amounts?

Answer: *For 2011, Allen must include the entire $8,000 of social security benefits when computing the taxable amount, even though he repayed $3,000 of the benefits in 2012. Allen includes $9,000 ($12,000 – $3,000) of benefits when calculating the 2012 taxable social security amount. The $3,000 repayment reduced the amount of Allen's 2011 benefits when computing the taxable amount for 2012.*

Question 3: Withdrawal of principal from a Roth IRA.

Jamie was age 50 when he set up two Roth IRA accounts in 2010. He contributed $1,000 to each account that year and $1,000 to each in 2011 and 2012, so he made total contributions to each account of $3,000. On July 10, 2012, he had $4,500 in Account One and $4,000 in Account Two. He withdrew all $4,500 from Account One. How much of the withdrawal was taxable?

Answer: *None. No portion of a distribution from a Roth IRA is taxable until the cumulative distributions from all the individual's Roth IRA accounts exceed the total amount of contributions (IRC Sec. 408A(d)(4)(B)). This is true even though the distribution in this case is not a qualified distribution because Jamie is not yet age 59½ and the five-year rule has not been met. Also, even though the distribution is from Account One, which has $3,000 of principal and $1,500 of earnings, the withdrawal is considered to come first from Jamie's $6,000 of regular annual Roth IRA contributions, so the entire withdrawal is tax-free and penalty-free.*

Question 4: Tax treatment of SIMPLE IRA distributions.

Antwan Patton, age 28, entered his employer's SIMPLE IRA plan on January 1, 2011. His employer made the first deposit into his SIMPLE IRA on January 15, 2011. Antwan quits on March 15, 2012, when he has $8,000 in his SIMPLE IRA. If he withdraws the $8,000, how can he avoid income tax and the penalty for early withdrawal?

Answer: *He must roll the $8,000 over into another SIMPLE IRA within 60 days. Since he has not participated in the SIMPLE IRA plan for two years, he cannot roll the proceeds over to another type of eligible retirement plan or Roth IRA. If he takes the distribution and does not roll it over to another SIMPLE IRA, the $8,000 will be subject to the 25% early distribution penalty as well as income tax.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. A married taxpayer and spouse have provisional income of $60,000 and social security benefits of $26,000. The amount of social security benefits included in income is:

    a. $22,100.

    b. $13,000.

    c. None.

    d. Unknown.

14. Which of the following is true regarding distributions from a Roth IRA?

    a. Distributions are taxable to the extent of the earnings.

    b. Distributions are first deemed to be a return of the initial contribution and nontaxable.

    c. Distributions are always tax-free.

    d. A qualified distribution is made after a five-taxable year period, and after the date the owner attains age 59½.

15. In which of the following situations can a client convert a traditional IRA into a Roth IRA?

    a. In the year 2010 or later regardless of AGI.

    b. The client files married filing separate.

    c. The account balance is under $100,000.

16. Rollover rules allow a participant to do which of the following?

    a. Roll over funds from retirement plans to a taxable account.

    b. Defer taxes on qualified distributions from a Roth IRA account.

    c. Roll over funds from retirement plans to an IRA.

    d. Defer taxes on minimum required distributions (MRD) from a retirement plan.

17. Which of the following is a tax consequence of a QDRO payment?

    a. The payments are taxed when received.

    b. The 10% additional tax on premature distributions applies.

    c. The distribution qualifies for rollover to an IRA if completed within 90 days.

    d. Lump-sum distributions to a beneficiary are not eligible for special averaging or capital gain treatment.

18. A 45-year-old client inherited a Roth IRA from her brother (age 60 when he died) in 2011 Which of the following statements best describes the next action he/she should take?

    a. The client can begin distributions the year her brother would have reached age 70 1/2.

    b. The client is exempt from taking any MRD in a future year as it is a Roth account and not subject to the RMD rules.

    c. The client should begin taking distributions over his/her single life expectancy in 2012.

    d. The client will need to recognize all of the earnings from the account within five years of the participant's death.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

13. A married taxpayer and spouse have provisional income of $60,000 and social security benefits of $26,000. The amount of social security benefits included in income is: **(Page 67)**

    a. $22,100. [This answer is correct. 85% of the social security received is taxable because provisional income exceeds the adjusted base amount of $32,000.]

    b. $13,000. [This answer is incorrect. This is the amount that would be included in income if provisional income was less than the adjusted base amount.]

    c. None. [This answer is incorrect. Some amount of the social security received is taxable at this level of provisional income.]

    d. Unknown. [This answer is incorrect. Provisional income measures the amount of social security includible in income.]

14. Which of the following is true regarding distributions from a Roth IRA? **(Page 72)**

    a. Distributions are taxable to the extent of the earnings. [This answer is incorrect. Distributions including earnings are not taxable if they are qualified distributions.]

    b. Distributions are first deemed to be a return of the initial contribution and nontaxable. [This answer is correct. Under the ordering rules, distributions are determined in a favorable order with contributions deemed distributed first.]

    c. Distributions are always tax-free. [This answer is incorrect. Only qualified distributions and distributions from the original contribution are tax-free.]

    d. A qualified distribution is made after a five-taxable year period, and after the date the owner attains age 59½. [This answer is incorrect. A qualified distribution is one that is made after a five-taxable year period and made after the date the owner attains age 59½, made to a beneficiary or the estate of the owner on or after the date of the owner's death, attributable to the owner's being disabled, or used under the first-time home purchase provision.]

15. In which of the following situations can a client convert a traditional IRA into a Roth IRA? **(Page 73)**

    a. **In the year 2010 or later regardless of AGI. [This answer is correct. Starting in 2010 there is no AGI limitation for conversion of a traditional IRA into a Roth IRA.]**

    b. The client files married filing separate. [This answer is incorrect. No conversions are allowed for individuals filing married filing separate returns.]

    c. The account balance is under $100,000. [This answer is incorrect. The balance in the account is not relevant.]

16. Rollover rules allow a participant to do which of the following? **(Page 78)**

    a. Roll over funds from retirement plans to a taxable account. [This answer is incorrect. Rollover of funds from retirement accounts would result in a taxable distribution and possible penalty.]

    b. Defer taxes on qualified distributions from a Roth IRA account. [This answer is incorrect. Qualified distributions from a Roth IRA are not taxable.]

    c. Roll over funds from retirement plans to an IRA. [This answer is correct. The rollover rules under the Internal Revenue Code allow participants to roll over funds from retirement plans to IRAs. The ability to roll over funds from a retirement account to an IRA retains the tax deferral on these funds.]

    d. Defer taxes on minimum required distributions (MRD) from a retirement plan. [This answer is incorrect. The tax code does not allow an MRD to be rolled over.]

17. Which of the following is a tax consequence of a QDRO payment? **(Page 84)**

    a. The payments are taxed when received. [This answer is correct. The IRS taxes the spouse or former spouse on a QDRO payment when it is received.]

    b. The 10% additional tax on premature distributions applies. [This answer is incorrect. The 10% additional tax on premature distributions does not apply to QDRO payment under the Internal Revenue Code.]

    c. The distribution qualifies for rollover to an IRA if completed within 90 days. [This answer is incorrect. All or part of the distribution qualifies for rollover to an IRA if completed within 60 days of receipt.]

    d. Lump-sum distributions to a beneficiary are not eligible for special averaging or capital gain treatment. [This answer is incorrect. Lump-sum distributions to a beneficiary may be eligible for special averaging or capital gain treatment if the original participant would have been eligible for that treatment.]

18. A 45-year-old client inherited a Roth IRA from her brother (age 60 when he died) in 2011. Which of the following statements best describes the next action he/she should take? **(Page 88)**

    a. The client can begin distributions the year her brother would have reached age 70 1/2. [This answer is incorrect. This is an option only if the owner dies prior to RBD and the spouse is the beneificiary.]

    b. The client is exempt from taking any MRD in a future year as it is a Roth account and not subject to the RMD rules. [This answer is incorrect. Inherited Roth accounts are subject to RMD rules.]

    c. The client should begin taking distributions over his/her single life expectancy in 2012. [This answer is correct. The client must begin distributions in the year following death to avoid recognition under the five-year rule.]

    d. The client will need to recognize all of the earnings from the account within five years of the participant's death. [This answer is incorrect. A beneficiary of a Roth IRA may stretch the receipt of the account over their single life expectancy.]

EXAMINATION FOR CPE CREDIT

Chapter 5

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

13. Which of the following is true regarding the taxability of social security income?

    a. 50% of social security is includible in taxable income.

    b. Between 50% and 85% of social security is taxable depending on provisional income.

    c Social security is exempt from tax.

    d. Do not select this answer choice.

14. When calculating the taxable portion of a withdrawal from a nondeductible traditional (not Roth) IRA, the taxpayer:

    a. Cannot use only the IRA from which the distribution was received.

    b. Must only consider the IRA account holding nondeductible contributions.

    c. Must include the basis and value of all retirement accounts.

    d. Do not select this answer choice.

15. Which of the following components of a Roth IRA is considered to be distributed first?

    a. Earnings.

    b. Contributions.

    c. Conversion contributions.

    d. All distributions are measured pro rata and contain a portion of each of the above.

16. When assets are rolled over from an employer plan to an IRA:

    a. Employers must withhold 25% of an eligible rollover distribution.

    b. The once-a-year limit on IRA to IRA rollovers doesn't apply.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

17. The Required Beginning Date for lifetime distributions of a participant's retirement income is usually:

    a. The retirement date.

    b. The year the participant turns 70½.

    c. By April 1 of the calendar year following the year in which the participant reaches 70½.

    d. Do not select this answer choice.

Chapter 6: Other Items of Income

Learning Objectives

Completion of this chapter will enable you to:

- Apply the rules covering education savings accounts and health savings accounts.
- Explain the tax treatment of certain other income items, including alimony recapture, tax refunds, unemployment income and other miscellaneous income.

Introduction

This chapter covers a variety of Form 1040 reporting issues and gross income topics that are outside the subject matter of the other income-related chapters in this course.

Recapture of Excess Alimony Payments

Alimony payments under a divorce decree or similar instrument are viewed in the Code as a shift of income from the payer to the payee. Generally, the payer can deduct the alimony while the payee must recognize the payments as income. To preserve the underlying theory that alimony is a shift of income between taxpayers and not disguised property settlements, the payments must meet a three-year recapture rule. This rule provides that the payer recapture excess alimony payments as income in the third post-separation year, while the payee is entitled to deduct the same amount from gross income. The excess alimony payments also are referred to as front-loaded payments, referring to excessive amounts paid in the early years.

Alimony payments made in either of the first two years may be subject to recomputation that could reduce alimony amounts (*Feldman v. Comm.*). Recomputation may occur if the purported alimony payment decreases by more than $15,000 in the second or third year of payment.

When the recomputation rule applies, it applies only in the third year. The recapture amount is the sum of the following two calculations:

- *Excess Second Year Payments* are calculated first. A second year payment is considered excessive by the amount it exceeds the sum of the third year payment plus $15,000.
- *Excess First Year Payments* are calculated next. A first year payment is excessive if it exceeds the sum of $15,000 plus 50% of the un-recaptured second year payment plus the third-year payment.

Example: Recapturing alimony.

Under the terms of their divorce agreement, Rick agreed to pay his ex-wife, Lisa, $5,000 per month for 24 months, beginning on June 1, 2009. In addition, he agreed to pay Lisa rehabilitative alimony of $65,000 in one payment on July 1, 2009.

Rick's Payments to Lisa

Year	Alimony Paid
2009	$ 100,000
2010	60,000
2011	25,000
Total Paid	$ 185,000

ALIMONY RECAPTURE WORKSHEET

Line	Description						
	1st Year Alimony		100,000				
	2nd Year Alimony		60,000				
	3rd Year Alimony		25,000				
	2nd Year Recapture:						
1	Alimony Paid in 2nd Year			1	60,000		
2	Alimony Paid in 3rd Year	2	25,000				
3	Plus Floor	3	**15,000**				
4	Allowed 2nd Year Alimony (add lines 2 and 3)			4	40,000		
5	2nd Year Recapture (subtract line 4 from 1)					5	20,000
	1st Year Recapture:						
6	Alimony Paid in 1st Year			6	100,000		
7	Alimony Paid in 2nd Year	7	60,000				
8	2nd Year Recapture (line 5)	8	20,000				
9	Net 2nd year alimony (subtract line 8 from line 7)	9	40,000				
10	Alimony Paid in 3rd Year	10	25,000				
11	Total 2nd and 3rd Year Alimony (add lines 9 and 10)	11	65,000				
12	Average (divide line 11 by 2)	12	32,500				
13	Plus Floor	13	**15,000**				
14	Allowed 1st Year Alimony (add lines 12 and 13)			14	47,500		
15	1st Year Recapture (subtract line 14 from 6)					15	52,500
	Combined Recapture:						
16	Total Alimony Recapture (add lines 5 and 15)					16	72,500

Note: Report recapture only in the 3rd year.

***FOR ALIMONY PAID AND DEDUCTED*, recapture is reported as income on Form 1040, line 11.**

***FOR ALIMONY RECEIVED AND REPORTED*, recapture is reported as deduction on Form 1040, line 29.**

Alimony recapture can unexpectedly be **triggered by** failing to make timely payments, reducing payments after a divorce decree modification, or changing payments due to adverse financial conditions.

Rehabilitative Alimony – A divorce decree may provide "rehabilitative alimony" for the payee's support. The recapture rules may still apply and such support payments may be reclassified as a property settlement.

How to avoid alimony recapture:

- Avoid second-year payments that exceed third-year payments by more than $15,000.
- Avoid first-year payments that exceed second-year payments by more than $7,500.
- Avoid third-year payments that have little or no amounts payable.
- Begin first-year payments as late in the first year as possible. First-year payments should then be less than total second-year payments.

Alimony recapture does **not** apply when:

- Payments are made under a temporary support order;
- An unforeseen job change results in an amendment to the original alimony order;
- Payments made over a period of at least three years are determined as a fixed percentage of a payer's income from a business, from property, or from compensation through regular employment or self-employment; or
- Payments terminate as a result of the death of either spouse or the remarriage of the recipient.

Reporting Refunds of Itemized Deductions under the Tax Benefit Rule

What Is the Tax Benefit Rule?

The tax benefit rule ordinarily requires taxpayers to include in gross income the amount of a prior year deduction when an event occurs that is fundamentally inconsistent with the premise of the deduction. An event is fundamentally inconsistent with the premise of a deduction if the deduction would have been precluded had the event occurred in the same tax year as the deduction.

Under IRC Sec. 111(a), if some or all of a prior year deduction provided no tax benefit because it failed to reduce tax or increase an NOL in the year deducted, the refund or recovery of the previously deducted amount is included in gross income only to the extent of the tax benefit derived from the original deduction. For example, a refund of a deductible personal expense (itemized deduction) is not subject to tax if the taxpayer used the standard deduction in the year the amount was paid or withheld. Furthermore, even if a taxpayer itemized in the prior year, only a portion of the current refund may be taxable if the prior year's deduction did not produce a full tax benefit.

The most common recoveries are those related to itemized deductions (e.g., state income tax and property tax refunds or credits, casualty loss insurance reimbursements). However, recoveries of nonitemized deductions are also subject to the tax benefit rule. These recoveries include such items as payments received for an amount previously deducted as a bad debt or claimed as a tax credit, other than the investment credit or foreign tax credit. For tax credits, current-year tax is increased by the amount of credit attributable to any current-year downward price adjustment or similar adjustment. No increase to tax is required if the taxpayer did not receive a tax benefit for the original credit.

Although the Tax Court (see *Streckfus Steamers, Inc.*) has held that the tax benefit rule does not apply when the original deduction was claimed in error and in a tax year that is now closed under the statute of limitations (i.e., the "erroneous deduction exception"), the circuit courts have repeatedly rejected this position, requiring instead that the recovered amounts be included in income. In *Hughes & Luce, LLP,* the 5th Circuit joined the 2nd (*Kahn*), 6th (*Liberty Bank & Trust Co.*), 7th (*Union Trust Co.*), and 9th (*Unvert*) in holding that the tax benefit rule applies even if the original deduction was erroneous and claimed in a closed year.

Reporting Partially Taxable Refunds

Generally, the taxable portion of a refund of a previously claimed itemized deduction is reported on the appropriate line of Form 1040 (line 10 for refunds of state and local income taxes and line 21 for other refunds). Most refunds are not reported on information returns filed with the IRS, so no further disclosure is needed. However, state and local tax refunds are reported on Form 1099-G (Certain Government Payments). Therefore, the IRS will match the Form 1099-G amount to the return to ensure the taxpayer reported the refund as income. This gives rise to tax return presentation problems when only part (or none) of the refund is properly includable in gross income. In such cases, the IRS recommends a statement be attached to the return reconciling the amount reported on Form 1099-G with the amount reported on line 10 of the return.

Recomputing taxes in the year a deduction was originally claimed generally is required to determine how much of a refund of a previously deducted amount is includable in gross income. Practitioners using tax preparation software can often use it for these computations. For example, the tax benefit derived from all or a portion of a particular itemized deduction in 2010 can be determined by rerunning the 2010 return (using the 2010 software) excluding the appropriate amount of the deduction.

Effect of the Prior-year Standard Deduction

If the taxpayer did not itemize in the year an expense was originally paid, no refund of that expense is taxable. If the taxpayer did itemize, a refund or recovery of an amount previously claimed as an itemized deduction is included in income, but only to the extent itemized deductions exceeded the standard deduction (i.e., produced a tax benefit).

Example: Standard deduction limits prior-year tax benefit.

John and Sue are married and file a joint return. They had taxable income of $50,000 and claimed $11,600 in itemized deductions in 2010. In 2011, they received a $700 refund of state and local taxes that had been paid and deducted in 2010. Itemized deductions of $200 produced a tax benefit in 2010 (since they exceeded the $11,400 standard deduction for 2010 by that amount). Therefore, the amount subject to tax from the recovery or refund of any itemized deduction cannot exceed $200, and the remaining $500 of the tax refund received in 2011 is nontaxable under the tax benefit rule.

Alternative Minimum Tax in Prior Year

Recovery of a previously deducted amount does not increase gross income if the deduction did not reduce the tax imposed under Chapter 1 of the Internal Revenue Code. That chapter encompasses several types of taxes, including the alternative minimum tax (AMT). If AMT applied in the year of deduction, the practitioner must recompute both regular tax and AMT to determine if a tax benefit was received.

Distributions from a Health Savings Account

Health savings accounts (HSAs) are intended to replace the Archer medical savings accounts (MSAs). Generally both of these accounts allow taxpayers to accumulate funds to pay for qualifying medical expenses. To the extent used for qualified medical expenses, any earnings on the account are tax-free. This section focuses on distributions from an HSA.

The HSA beneficiary (the individual for whom the account is set up) can take tax-free withdrawals to pay uninsured medical expenses for the account beneficiary, spouse, and dependents that would be deductible as itemized medical expenses. Tax-free withdrawals can also be made to purchase nonprescription drugs. But, items that merely benefit overall health (e.g., vitamins) are not considered nonprescription drugs. See the list on the following page.

In a situation involving a child of divorced parents, according to Rev. Proc. 2008-48, regardless of whether the custodial parent releases the claim to the personal exemption, a child will be considered a dependent of both parents for purposes of tax-free HSA distributions for qualified medical expenses (assuming all other requirements for the noncustodial rule are met).

Withdrawals not used for qualifying medical expenses are taxable, regardless of when they are made. In addition, a 10% penalty tax applies to such distributions unless they occur after the beneficiary reaches the Medicare eligibility age (currently, age 65). The 10% penalty tax is also waived for withdrawals after the account beneficiary becomes disabled or dies.

Generally, health insurance premiums are not qualified medical expenses, except for the following:

- Qualified long-term care insurance,
- COBRA health care continuation coverage, and
- Health care coverage while an individual is receiving unemployment compensation.

For individuals over age 65, premiums can be paid from an HSA for Medicare Part A, Part B, and Part D (according to IRS Notice 2008-59), Medicare HMO, and the employee's share of premiums for employer-sponsored health insurance, including premiums for employer-sponsored retiree health insurance. However, if the account beneficiary is under age 65, but the beneficiary's spouse is age 65 or over, Medicare premiums for coverage of the spouse are not qualified medical expenses (IRS Notice 2008-59, Q&A 30). Premiums for Medigap policies are not qualified medical expenses.

Rollovers from HSAs

HSA distributions can be rolled over into another HSA tax-free as long as another tax-free rollover has not been made within the previous 12 months. However, the rollover must occur by the 60th day after the day on which the beneficiary receives the distribution.

Divorce-related Transfers of HSAs

The transfer of an individual's interest in an HSA to a spouse or former spouse under a divorce or separation instrument is not considered a taxable distribution to either party. Subsequently, the transferee is considered the HSA beneficiary.

HSAs—Reimbursable Over-the-Counter Medical Items

Eligible Expenses:

The following are over-the-counter (OTC) items that the IRS has determined to be primarily for medical care and that can be reimbursed when purchased in reasonable quantities without a medical practitioner's note.

- ☐ Allergy Medicine
- ☐ Antacids
- ☐ Bactine
- ☐ Band-Aids/bandages
- ☐ Bug-bite medication
- ☐ Anti-diarrhea medicine
- ☐ Calamine lotion
- ☐ Carpal-tunnel wrist supports
- ☐ Cold medicines
- ☐ Cold/Hot packs for injuries
- ☐ Condoms
- ☐ Contact lens cleaning solution
- ☐ Cough drops
- ☐ Diaper rash ointments
- ☐ First aid cream
- ☐ First aid kits
- ☐ Hemorrhoid medication
- ☐ Incontinence supplies
- ☐ Laxatives
- ☐ Liquid adhesive for small cuts
- ☐ Menstrual cycle products for pain and cramp relief
- ☐ Motion sickness pills
- ☐ Nasal sinus sprays
- ☐ Nasal strips
- ☐ Nicotine gum or patches for stop-smoking purposes
- ☐ Pain reliever
- ☐ Pedialyte for ill child's dehydration
- ☐ Pregnancy test kits
- ☐ Products for muscle or joint pain – Ben Gay and Tiger Balm, for example
- ☐ Reading glasses
- ☐ Rubbing alcohol
- ☐ Sinus medications
- ☐ Sleeping aids used to treat occasional insomnia
- ☐ Special ointment or cream for sunburn
- ☐ Spermicidal foam
- ☐ Thermometers (ear or mouth)
- ☐ Throat lozenges
- ☐ Visine and other eye products
- ☐ Wart remover treatment

Dual Purpose:

Some dual-purpose OTC items can be reimbursed if they are used for a medical purpose. They must be accompanied by a medical practitioner's note stating that the person has a specific medical condition and the doctor recommends the OTC drug to treat it and the treatment is not a cosmetic procedure.

- ☐ Acne treatment (Retina A) – only to treat a specific medical condition such as acne vulgaris.
- ☐ Dietary supplements or herbal medicines to treat a specific medical condition in narrow circumstances.
- ☐ Fiber supplements under narrow circumstances.
- ☐ Glucosamine/Chondroitin for arthritis or other medical condition.
- ☐ Orthopedic shoes and inserts (for orthopedic shoes, you can be reimbursed only for the extra cost over buying nonorthopedic shoes).
- ☐ OTC hormone therapy and treatment for menopause for symptoms such as hot flashes and night sweats.
- ☐ Pills for persons who are lactose intolerant.
- ☐ Prenatal vitamins
- ☐ St. John's Wart – for depression
- ☐ Sunscreen
- ☐ Weight-loss drugs to treat a specific disease (including obesity).

Ineligible Expenses:

Some OTC items will not be reimbursed under any circumstances since they are toiletries or cosmetics or likely to be primarily for general health and well-being,

- ☐ Chap stick
- ☐ Face cream, moisteners
- ☐ Medicated shampoos and soaps
- ☐ One-a-day vitamins
- ☐ Suntan lotion
- ☐ Teeth whitening (Rev. Rul. 2003.58)

Transfers at the Account Beneficiary's Death

Surviving Spouse Is Named as Beneficiary. If the HSA beneficiary's surviving spouse acquires the beneficiary's interest in the HSA because he or she was the designated beneficiary of the HSA when the original account beneficiary dies, the HSA is treated as if the surviving spouse were the original account beneficiary.

Nonspouse Beneficiary. If a person other than the surviving spouse acquires the account beneficiary's interest in an HSA due to the account beneficiary's death, the account ceases to be an HSA and its date-of-death value is included in the transferee's taxable income for the tax year in which the account beneficiary dies. The income amount is reduced by any qualified medical expenses of the decedent paid by the transferee within one year after the date of death. Also, the beneficiary can claim a Section 691 deduction for any federal estate tax paid and attributable to the HSA that he or she includes in taxable income.

If the HSA does not have a designated beneficiary (in the event of the original account beneficiary's death) or the estate is the designated beneficiary, the date of death value of the HSA is included in the account beneficiary's final Form 1040.

Understanding Education Savings Accounts

Congress created Coverdell Education Savings Accounts (CESAs) for the purpose of paying the qualified education expenses of an individual designated beneficiary. Contributions to CESAs are not deductible; instead, the tax benefit is derived from the tax-free accumulation of earnings in an account and tax-free distributions if used for qualified education expenses.

Qualified educational expenses include not only postsecondary education expenses, but also include expenses at public, private, or religious elementary and secondary education schools (i.e., Kindergarten to 12th grade). The definition of qualifying expenses is fairly broad and includes:

- Tuition and fees;
- Academic tutoring;
- Special needs service in the case of a special needs beneficiary;
- Books, supplies, and other equipment;
- Room and board;
- Uniforms and transportation costs; and
- Supplementary items and services, including extended-day programs.

Expenses for the purchase of any computer technology, equipment, Internet access, and related services are permitted if used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school.

Contribution Limitations

Contributions to CESAs are:

1. Limited to a **maximum of $2,000** per-child, per-year.
2. The beneficiary must be under age 18 at the time of the contribution. There is no age limit for a student with special needs as defined by regulations, which have yet to be issued.
3. Not deductible; and
4. Not taxable to the beneficiary.

CESAs can be invested in any type of investment vehicle (this provides more **flexibility** than the 529 qualified tuition plan's restricted investment vehicles).

In the case of contributors who are individuals, the $2,000 contribution phases out ratably for contributors with modified AGI as follows:

Filing Status	2010 and 2011 AGI Phase-out
MFJ and Surviving Spouse	$190,000–$220,000
Single and Head of Household and MFS	$95,000–$110,000

- Modified AGI includes foreign earned income, foreign housing costs and income from certain U.S. possessions and Puerto Rico.
- A child may contribute to his/her own CESA.
- Anyone can contribute if under the income limitations. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) clarified that corporations and other entities, including tax-exempt organizations, are permitted to make contributions to CESAs, regardless of the amount of the organization's income during the year of contribution.

  Parents or others who are restricted from contributing to the CESA for a student because of the modified AGI limitations should consider making a cash gift to the student **or** another eligible person, who then contributes the amount to the CESA.
- Contributions for any given year must be made no later than April 15 of the following year.
- Annual contributions in excess of $2,000 are subject to a 6% tax which is annually imposed on the beneficiary. The penalty tax will not apply if any excess contributions, and related earnings, are withdrawn by June 1 of the following year.
- Contributions are allowed to a CESA and a 529 Plan for the same beneficiary.

Beneficiaries of CESAs should receive a Form 5498 (Contribution Information) showing the amount contributed during the year on their behalf. If the total of the amounts shown on all of the beneficiary's Forms 5498 exceeds $2,000, an excess contribution has occurred and corrective action should be taken.

Distributions

Distributions from a CESA are income-tax free up to qualified higher education expenses, regardless of whether the designated beneficiaries are enrolled full-time, half-time, or less than half-time at an eligible educational institution.

1. A designated beneficiary's room and board may qualify as higher education expenses only if he/she is enrolled at least half-time.
2. When distributions exceed the beneficiary's qualified education expenses, a portion of the earnings included in the withdrawal is taxed to the beneficiary.
3. When a CESA distribution is included in the beneficiary's income, an additional 10% penalty tax applies to the taxable portion of the distribution, unless the distribution is made:
    a. Because the beneficiary dies or becomes disabled.
    b. As a result of the beneficiary receiving a nontaxable scholarship or similar assistance, to the extent the distribution does not exceed the assistance.
    c. Returns of excess contributions to CESAs are also excluded from the penalty if certain conditions are met.
4. Part IV of Form 8606 is used to compute the taxable amount, which is carried to page 1 of Form 1040.

Example: Ed has contributed $6,000 over the years to the CESA of his daughter, Grace. Grace is ready to attend college and the account has a total balance of $10,000, representing total earnings of $4,000. Grace withdraws $2,000 from the account. For the year, she only incurs $1,600 of qualified higher education expenses.

The withdrawal consists of $1,200 of contributions [($6,000 total contributions ÷ $10,000 total balance) × $2,000] and $800 of earnings. There is a $400 excess distribution ($2,000 withdrawn less $1,600 of qualified expenses). The taxable amount is the amount of the excess attributable to earnings, which in this case is $160 [$400 excess distribution × ($800 earnings ÷ $2,000 distribution)]. Grace must include the $160 in income and pay a 10% penalty on that amount.

The American Opportunity Tax Credit (formally known as the Hope Credit) and Lifetime Learning credits may be claimed in the same year as exclusions from income are taken for distribution from CESAs on behalf of the same student. The CESA distribution must not be used to pay for the same educational expenses for which a credit is claimed.

Mandatory Distribution and Rollovers of CESAs

If the balance in a CESA account is not used by the time the beneficiary reaches age 30, then any remaining amounts must be distributed within 30 days after the beneficiary reaches age 30. Any earnings included in the distribution are subject to income tax and a 10% penalty can be avoided by having the CESA rolled over to another family member under age 30.

- The rollover must be within 60 days of distribution.
- Only one distribution can be rolled over within a 12-month period.

- The rollover must be to an individual family member who is under age 30, including a child or a descendent of a child; a stepchild; a brother, sister, stepbrother, or stepsister; a father, mother, or ancestor of either; a stepfather or stepmother; a nephew or niece; an uncle or aunt; and all in-laws and spouses of any of the above.

A big disadvantage of the CESA compared to the 529 is that you cannot get the money back. However, a CESA can be rolled to a 529 account.

Transfer of Beneficiary's Interest

The transfer of a beneficiary's interest in a CESA to a spouse or former spouse under a divorce or separation agreement is:

- Not a taxable transfer; and
- Is treated as a CESA in which the spouse or former spouse is the designated beneficiary.

The tax treatment of a transfer because of death depends on who the transferee is:

- A surviving spouse or family member, as defined earlier, treats a CESA as though he/she is the designated beneficiary.
- If the transferee is someone other than a surviving spouse or family member, the distribution is taxable to the transferee at the date-of-death fair market value.

Estate Tax Valuation

For estate tax purposes, the value of an interest in a CESA is includible in the estate of the designated beneficiary, not the contributor.

Gift Tax Considerations

Contributions to CESAs are treated as completed gifts of a present interest from the contributor to the beneficiary for gift tax purposes. However, an individual's contribution to a designated beneficiary's CESA is not subject to gift tax or generation-skipping transfer tax provided the contribution, when combined with other gifts made to the beneficiary during the year, does not exceed the annual gift tax exclusion amount of $13,000 for 2011, or in the case of a married couple, $26,000. Donors can elect to take a CESA contribution into account over a five-year period for gift tax purposes if the donor's total gifts for the year to the beneficiary exceed the allowable gift tax exclusion. The election to spread transfers ratably over the five-year period is made by completing a box on Schedule A of Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return). Contributions do not qualify as Section 2503(e) transfers, which generally allows unlimited gift transfers when paid directly for an individual's tuition.

Using Qualified Tuition Programs

Qualified tuition programs (QTPs; also called 529 Plans) are programs for prepaying or saving for higher education costs. These programs enable a person to (1) prepay tuition benefits on behalf of a beneficiary so that the beneficiary is entitled to a waiver or a payment of qualified higher education expenses, or (2) contribute to a savings account that is established for paying the higher education expenses of the beneficiary. Most states and the District of Columbia have a 529 Plan(s).

529 Plans are individually designed by sponsoring states or institutions. They are **not federal plans**. As a result, there is a tremendous amount of variety in the programs offered and the fees charged. Taxpayers are well advised to analyze the various plans to ensure their ultimate education, investment, tax needs, and goals are met. Regulators are currently reviewing the 529 disclosure framework, consistency, clarity and understandability.

Investment Decisions

The investment decisions of 529 plans are as follows:

1. **Prepaid tuition plans** allow the taxpayer to pay for future tuition costs in today's dollars on behalf of a designated beneficiary. They are much like a futures contract pegged to the tuition rate. Prepaid tuition plans provide a hedge against tuition inflation.
2. **Savings plans** invest in different ways to pay all qualified higher education expenses on behalf of the beneficiary. Typical portfolios offer money market funds, stock funds, bond funds, CD's and various combinations of these funds.

Age-weighted plans are designed to be higher growth during the beneficiaries early years and then convert to safer investments as the beneficiary approaches college age. This may be a good investment type for someone who does not review their investments regularly.

Roll from a prepaid account (if available) to a savings plan if the plan permits and investment goals change.

1. Only the 529 Plan administrators may make investment decisions, not the contributor.
2. Final regulations under IRC Sec. 529 will provide that a 529 Plan program does not violate IRC Sec. 529(b)(4) if it permits a change in the investment strategy once per calendar year **and** upon a change in the designated beneficiary of the account.
3. Consideration should also be given to the investment manager, investment options, fees, and expense charges.

Qualified Expenses

Qualified higher education expenses include **tuition, fees, books, supplies and equipment** required for the enrollment or attendance of a designated beneficiary. In addition, if the beneficiary is **enrolled at least half time, reasonable room and board also qualifies**.

Expenses that are taken into account in calculating the Hope or Lifetime Learning credits do not qualify as educational expenses under IRC Sec. 529.

Contributions

There are **no AGI limitations** imposed on the contributor or the beneficiary.

The 529 plan creates **estate planning opportunities:**

- The contributor retains control of the assets until distributions are made to beneficiaries.
- The contributor retains control of when and how much is distributed.

- The contributor can change the beneficiary.
- A contribution is treated as a completed gift of a present interest from the contributor to the beneficiary.
    - The 2011 contribution is eligible for the **$13,000 annual gift tax exclusion.**
    - A special election is available by filing gift tax returns and electing to take the contribution ratably over five years.

> **Example: Electing to spread contributions over five years.**
>
> Grandma Birdie said "bye-bye" to a gift of $60,000 to a QTP for her grandson, Lucky. Birdie's accountant filed Form 709, Box B on Schedule A of the tax return, and elected to take the five-year-averaging election, allowing funds to earn tax-deferred income sooner and not lose any of Birdie's unified credit for estate tax purposes.

- **Large contributions are permitted in many 529 plans.** Currently, Pennsylvania leads all other states allowing contributions until the beneficiary's account balance reaches $368,600.
- Most states allow nonresidents to contribute to their plans.
- Anyone can contribute to a plan for a given beneficiary.

> **Example:** Wilson, Bob's next door neighbor, graduates from high school. Bob sets up a 529 plan of $1,000 as a graduation present. Bob is permitted to do this even though he is not related. Bob may be able to deduct the present at the state level depending on what state he lives in.

Check out **upromise.com** or **littlegrad.com** and register with many companies from gas to groceries and earn 529 dollars.

Withdrawals and Earnings

- Distributions from 529 Plans are excluded from the income of the beneficiary and the contributor if used for qualified education expenses.

  On January 18, 2008, the IRS published advance notice of future proposed regulations regarding abuse of the 529 distribution rules to avoid gift and estate tax.

- Nonqualified withdrawals distributed to the account owner or beneficiary are taxed to the contributor and penalized.

  EGTRRA of 2001 eliminated the requirement that 529 Plans impose a penalty on nonqualified withdrawals. Instead, the same 10% federal additional tax that currently applies to nonqualified withdrawals from Coverdell Education Savings Accounts is extended to 529 Plans.

  This may have a significant impact in a few states that do not have separately stated penalties. Instead, they reduce the value of prepaid contracts for cancellations and refunds. For these programs, the new federally imposed 10% penalty will be **in addition**

to the reduction of the contract value. Taxpayers need to be alerted to this issue. This should be taken into consideration when choosing a 529 Plan.

- **Penalties are avoided** if the withdrawals are made on account of the designated beneficiaries' **death**, **disability**, or are made on account of a tax-free **scholarship** or other educational assistance allowance or payment received by the designated beneficiary.
- Tax on earnings and the penalty are avoided if withdrawals are rolled over to qualified beneficiaries.

  Most 529 savings plans have no time limit on withdrawal. There would be significant tax deferral by allowing the 529 plan to grow until retirement and pay the tax and penalty when in a presumably lower tax bracket.
- Distributions that are not used for education are not included as income if **rolled over within 60 days.** This rollover can be to a 529 Plan of an existing or a new beneficiary who is a member of the old beneficiary's family (see following).

Member of the Family

- A son or daughter (natural or legally adopted), or a descendant of either;
- A stepson or stepdaughter;
- A brother or sister (by whole or half-blood), or stepbrother or stepsister;
- The father or mother, or an ancestor of either;
- A stepfather or stepmother;
- A niece or nephew;
- An aunt or uncle;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;
- The spouse of the designated beneficiary (who must be a member of the same household and have the same principal place of abode) or the spouse of any of the relatives listed above (who must be a member of the same household and have the same principal place of abode); or
- A first cousin.

- Not all states have conformed to the IRC Sec. 529 provisions of the EGTRRA of 2001. Accordingly, some distributions may be taxable at the state level.

529 Plans are required to file information returns for education furnished or distributions made from a QTP. Form 1098-G (Certain Government and Qualified State Tuition Program Payments) is used for this purpose.

Deductions and Credits

- No federal deductions or credits are allowed for contributions to 529 plans.
- Four states permit a full state deduction. Twenty-nine states allow at least a partial deduction or credit. Again, there are significant differences how deductions are handled at the state level. Some states only allow tax benefits for contributions to their own plan. Other states allow tax benefits no matter which state's plan is used.

If your state only allows tax incentives for contributions made to their own state plan, taxpayers may contribute to their home state plan, take advantage of the tax incentives, and using the rollover rules, roll the contribution over to another state's plan. Good idea. However, watch out as some states (Oklahoma and Indiana) have recognized this loophole and have closed it.

Selected Other Income Items

Unemployment Compensation

Income. Unemployment benefits are generally periodic cash payments made to an individual taxpayer paid by the federal and state government to compensate a worker and the worker's family for the loss of income that is caused by an involuntary layoff. All unemployment benefits or other payments "in the nature of" unemployment benefits are includible in the recipient's gross income and the income (and withholding) is reported on Form 1099-G.

Repayments. Current-year overpayments that were received and repaid in the current year should be subtracted from the total received. Overpayments of $3,000 or less from prior years that were repaid in the current year should be reported on Schedule A as a miscellaneous deduction subject to the 2% limitation. Overpayments greater than $3,000 from prior years that were repaid in the current year can use either of two methods that result in the lowest tax:

1. Miscellaneous deduction on IRS Schedule A **not** subject to the 2% limitations, or
2. Calculate a current year credit and report it on Form 1040, Page 2, writing "IRC 1341," based on the difference in tax in the year originally received (IRS Pub. 525).

New Law: For 2009, up to $2,400 of unemployment compensation is excludable from the recipient's gross income (American Recovery and Reinvestment Act of 2009).

Disability Income

Disability income is not taxable if the individual paid the premiums on the disability policy or contributed (on an after-tax basis) to an employer-sponsored disability plan. Disability income is taxable if an employer contributes to a funded plan or pays the policy's premiums for the employee (*Kees*). When the taxpayer reimbursed his firm for disability premiums paid by the firm by deducting the premium amounts from his shareholder loan account, the Tax Court ruled that disability benefits received by this taxpayer were excludable from his gross income under IRC Sec. 104(a)(3). From the inception of the policy until the premiums were waived, the taxpayer treated the premiums as personal items and paid his share of the premiums through his loan account, and the firm never deducted them (*Cotler*).

Payments for loss of use or function of the body (e.g., limb) are always nontaxable. Individuals receiving taxable disability income for permanent and total disability may be able to claim the credit for the elderly or disabled.

For group policies purchased with both employer and employee contributions, the taxable portion of any benefits received is determined by the ratio of premiums paid by the employer to total net premiums for the three most recent years for which net premiums are known. This three-year "lookback" rule can cause a portion of benefits paid under group disability insurance to be taxable if the employer has paid some or all of the premiums in the past, even if the employee paid all the premiums in the year the benefits are received.

Plans that allow employees to annually elect whether disability insurance is paid with employer or employee funds are not subject to the lookback rule. If the employee becomes disabled in a year for which he or she has elected to have the coverage paid with his own funds (i.e., after-tax), any resulting benefits are tax-free. Likewise, any benefits attributable to a disability that occurs in a year the employee has elected to have the coverage paid by the employer (i.e., pre-tax) are fully taxable. A plan that is amended to allow employees to make this annual election is considered a new plan. Therefore, the “lookback” rule does not apply to the amended plan. These rules apply to both short-term and long-term disability benefits.

Social security disability benefits are treated in the same manner as other social security benefits under IRC Sec. 86 (*Dela Cruz*). See *Reimels*, for example, in which a veteran’s social security disability benefits could not be excluded from gross income even though the benefits resulted from exposure to Agent Orange during the Vietnam War.

Workers’ Compensation

Amounts received by an employee as compensation under state or federal workers’ compensation acts for personal injuries or sickness incurred on the job are not taxable, unless the amounts received offset previously deducted medical expenses. However, to the extent the workers’ compensation benefits reduce or offset social security benefits, they are treated and taxed as social security benefits *(Mikalonis)*. Amounts received under a private arrangement, such as between a corporation and shareholder-employee, are taxable since not received pursuant to a workers’ compensation statute (*American Foundry*).

Bartering Income

In examinations, the IRS often asks individual taxpayers whether they engaged in any bartering transactions. Bartering is the exchange of property or services for another’s property or services. The FMV of the goods or services received must be included in the taxpayer’s gross income on the date received. A taxpayer can offset the bartering income with the cost (not FMV) of any property exchanged in such a transaction, as would be the case in an ordinary sale of inventory. Taxpayers who trade services, instead of property, can offset the income with any expenses that would normally be deducted against income generated by producing that service (e.g., supplies, telephone, etc.). Practitioners should attempt to obtain a written representation from clients who participate in bartering transactions. It should be obtained before the preparation of any applicable tax returns.

A bartering transaction may consist of two transactions. The first is the receipt of income, equal to the FMV of the goods or services received. Next, if the goods and services received are used in the taxpayer’s business or income-producing activity, a deduction should be available, just as it would be if the goods or services had been obtained with cash (*Solon*).

Example: Bartering income.

Courtney is a self-employed attorney. She exchanges her services for a painting worth $5,000 that she displays in her home. She must include the value of the painting ($5,000) in income. She can deduct only the out-of-pocket expenses incurred to furnish the legal fees. This is the same result as if she had collected $5,000 in cash and used the cash to buy the painting.

Example: Bartering income (continued).

Variation: Assume instead that Courtney exchanged her legal services for two months rent (worth $5,000) for the office space where she conducts her legal practice. Here, she would have $5,000 income, but also a $5,000 deduction for rental expense on her Schedule C reporting income from her legal practice. Again, the result is the same as if she had received the $5,000 in cash and used it to pay the rent on her office space.

Military Income and Related Issues

Active members of the U.S. Armed Forces are subject to special tax rules. An active member of the U.S. Armed Forces includes commissioned officers and enlisted personnel in all regular and reserve units under the control of the Secretaries of the Defense, Army, Navy, and Air Force. The Armed Forces also include the Coast Guard, but not members of the U.S. Merchant Marine or the American Red Cross.

Income Exclusions. Active members of the U.S. Armed Forces receive many types of pay and benefits that are excludable from income, including certain pay received by members serving in designated combat zones, living, family, moving, and travel allowances, and in-kind military benefits (e.g., medical and dental care, legal assistance, dependent care, and travel on government aircraft).

Special Rules for Filing Returns. The due date for filing returns, paying tax, or claiming a credit or refund is extended while taxpayers are serving in a combat zone or are deployed outside of the U.S. and participating in contingency operations.

Also, if a member of the Armed Forces dies while serving in a combat zone, or from wounds, disease or injury incurred while doing so, his or her income tax liability is forgiven for the year of death. It is also forgiven for any previous tax year (still open under the statute of limitations) that ended on or after the first day the member was in active service in a combat zone. Similar tax forgiveness applies to military or civilian U.S. employees who die from wounds or injury incurred in a terrorist or military action. See Rev. Proc. 2004-26 for procedures for filing requests for credit or refund under these rules.

Designated combat zones can be identified at the IRS website (**www.irs.gov**) by entering the words “combat zone” in the search feature.

For more information on these and other special issues that apply to members of the Armed Forces, see IRS Pub. 3, “Armed Forces’ Tax Guide,” in general, Notice 2002-17 for specific guidance on the tax relief provided for U.S. military and support personnel involved in military operations in Afghanistan, and Notice 2003-21 for tax relief guidance for military and support personnel involved in Operation Iraqi Freedom. In addition, the IRS website (**www.irs.gov**) under the “individuals” tab includes a section called “Tax Information for Member of the U.S. Armed Forces.”

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. When does alimony recapture apply?

    a. When payments decrease by more than $15,000 from Year 2 to Year 3.

    b. When payments decrease by more than $15,000 from Year 1 to Year 2.

    c. When payments decrease by more than $15,000 from any year to the next year.

    d. When alimony payments are made under a temporary support order.

20. Angel (single) deducted $3,500 in state sales taxes in 2011. She received a refund of $350. Her total itemized deductions were $14,200. Her tax liability in the prior year was $9,400. She was not subject to AMT. What amount of refund is includable in her gross income for the year of the refund?

    a. No amount is includable as she was not subject to AMT.

    b. All of the refund received or $350.

    c. 10% of the refund or $35 since 10% of the amount paid was refunded.

21. Jon and Thelma Smith have a six-year-old son, Mark. To save for his education expenses, they intend to contribute $2,000 to an educational account naming Mark the designated beneficiary. For 2011, the Smith's modified AGI is $225,000. Which of the following is **not** an option for the Smiths?

    a. Jon and Thelma are eligible to make a $2,000 contribution to a CESA.

    b. Jon and Thelma could gift the funds to Mark and let Mark make his own contribution to a CESA.

    c. Jon and Thelma could consider making a contribution to a Qualified Tuition Program (QTP) as an alternative.

22. Which of the following is a benefit of a Section 529 plan (otherwise known as a qualified tuition plan)?

    a. A federal limitation on how much can be contributed annually.

    b. An ability to contribute regardless of income levels.

    c. A tax deduction for contributions.

    d. The deferral of income on assets contributed until used for qualified higher education.

23. Payments received due to disability are:

    a. Nontaxable if the individual paid the premiums.

    b. Nontaxable if the individual's employer paid the premiums and the premiums were excludible.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

19. When does alimony recapture apply? **(Page 105)**

    a. When payments decrease by more than $15,000 from Year 2 to Year 3. [This answer is correct. Under the Code, a second year payment is considered excessive by the amount it exceeds the sum of the third year payment plus $15,000.]

    b. When payments decrease by more than $15,000 from Year 1 to Year 2. [This answer is incorrect. The second and third year payments must be considered.]

    c. When payments decrease by more than $15,000 from any year to the next year. [This answer is incorrect. Alimony recapture only applies for payments made in the first three years.]

    d. When alimony payments are made under a temporary support order. [This answer is incorrect. Under the Internal Revenue Code, alimony recapture doesn't apply in this situation or in certain other situations such as when an unforeseen job change results in an amendment to the original alimony order.]

20. Angel (single) deducted $3,500 in state sales taxes in 2011. She received a refund of $350. Her total itemized deductions were $14,200. Her tax liability in the prior year was $9,400. She was not subject to AMT. What amount of refund is includable in her gross income for the year of the refund? **(Page 108)**

    a. No amount is includable as she was not subject to AMT. [This answer is incorrect. The preparer must determine the amount Angel benefited from the refunded deduction for regular tax.]

    b. All of the refund received or $350. [This answer is correct. The full amount of the refund would be includable because her itemized deductions for 2011 exceeded the standard deduction by more than the amount of the refund.]

    c. 10% of the refund or $35 since 10% of the amount paid was refunded. [This answer is incorrect. She received a tax benefit for more than 10% of the refund.]

21. Jon and Thelma Smith have a six-year-old son, Mark. To save for his education expenses, they intend to contribute $2,000 to an educational account naming Mark the designated beneficiary. For 2011, the Smith's modified AGI is $225,000. Which of the following is **not** an option for the Smiths? **(Page 112)**

    a. Jon and Thelma are eligible to make a $2,000 contribution to a CESA. [This answer is correct. Their AGI is greater than the maximum phase-out amount of $220,000, making them ineligible to make a $2,000 contribution to a CESA.]

    b. Jon and Thelma could gift the funds to Mark and let Mark make his own contribution to a CESA. [This answer is incorrect. According to the Coverdell Education Savings Account regulations, Mark may contribute to his own CESA.]

c. Jon and Thelma could consider making a contribution to a Qualified Tuition Program (QTP) as an alternative. [This answer is incorrect. Under IRC Sec. 529, Jon and Thelma can prepay tuition benefits on behalf of their son, Mark.]

22. Which of the following is a benefit of a Section 529 plan (otherwise known as a qualified tuition plan)? **(Page 116)**

    a. A federal limitation on how much can be contributed annually. [This answer is incorrect. No limitation exists on how much can be contributed.]

    b. An ability to contribute regardless of income levels. [This answer is correct. Anyone of any income level can make contributions to a Section 529 plan.]

    c. A tax deduction for contributions. [This answer is incorrect. There is no federal deduction for contributions to a Section 529 plan.]

    d. The deferral of income on assets contributed until used for qualified higher education. [This answer is incorrect. Earnings are tax-free if used for qualified higher education expenses.]

23. Payments received due to disability are: **(Page 118)**

    a. Nontaxable if the individual paid the premiums. [This answer is correct. Under IRC Sec. 104(a), disability income is not taxable if the individual paid the premiums on the disability policy or contributed (on an after-tax basis) to an employer-sponsored disability plan.]

    b. Nontaxable if the individual's employer paid the premiums and the premiums were excludible. [This answer is incorrect. Disability income is taxable if an employer contributes to a funded plan or pays the employee's premiums.]

EXAMINATION FOR CPE CREDIT

Chapter 6

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

18. If alimony in year one is $50,000, Year 2 is $25,000 and Year 3 is $5,000, which of the following is true?

    a. Alimony recapture will apply in the third year.

    b. Alimony recapture will apply in the second year.

    c. Alimony recapture will not apply if the payments were due to a decree.

    d. Do not select this answer choice.

19. The tax benefit rule is responsible for which of the following?

    a. Tax equity doctrine.

    b. The transfer of income via the alimony deduction.

    c. The ability to deduct social security repayments.

    d. The inclusion of certain state tax refunds as income.

20. Distributions from medical savings accounts and health savings accounts are:

    a. Taxable when withdrawn from the account.

    b. Nontaxable if used for qualifying medical expenses.

    c. Nontaxable if used for qualifying medical expenses after age 59½.

    d. Are not transferable in a divorce.

21. Which of the following expenses is not reimbursable under an HSA?

    a. Teeth whitening.

    b. Pregnancy test kit.

    c. Rubbing alcohol.

    d. Cough drops.

22. If an employee elects to have his disability coverage paid by his employer (pre-tax) and he becomes disabled:

    a. Payments received will be taxable.

    b. Payments received will be nontaxable.

    c. Payments may or may not be taxable depending on how many years the premiums were paid on a pre-tax basis.

    d. Do not select this answer choice.

Chapter 7: Adjustments to Income

Learning Objectives

Completion of this chapter will enable you to:

- Apply the rules relating to contributions to various types of IRAs.
- Identify and determine other adjustments to income, including the self-employed health insurance deduction, health savings accounts, moving expenses and alimony.

Introduction

Adjusted gross income (AGI) is more than a subtotal on an individual tax return. AGI is the benchmark for claiming certain deductions or credits including rental real estate losses, IRA contributions, medical expenses, casualty losses, charitable contributions, and miscellaneous itemized deductions. AGI is defined by IRC Sec. 62 as gross income less certain specified deductions. Most of these deductions, which are categorized on Form 1040 as "adjustments to income," are allowed by IRC Sec. 62, although some are authorized in other sections of the Code.

Contributions to Traditional IRAs

Maximum Allowable Contributions

Contributions to traditional IRAs can be deductible, partly deductible, or nondeductible. Regardless of how the contribution is treated, the initial step is determining the maximum amount the taxpayer is allowed to contribute.

For 2011, IRA contributions generally can be made up to the lesser of (1) $5,000 ($6,000 if age 50 or older by the end of the year) or (2) 100% of the individual's compensation. Compensation includes wages, salaries, other amounts derived from or received for personal services actually rendered including self-employment income, and alimony. For married couples, IRA contributions up to $5,000 ($6,000 if age 50 or older by the end of 2011) can be made for each spouse if the combined compensation of both spouses is at least equal to the contributed amount and they file a joint return. Contributions must be made in cash.

The contribution limit described in the preceding paragraphs apply to the combined contributions to all of the taxpayer's traditional and Roth IRAs. Thus, an under age 50 taxpayer who contributes $5,000 to a Roth IRA cannot also contribute to a traditional IRA, and vice versa. Allowable contributions can also be split between the two in any fashion (e.g., $5,000 contribution split so $1,500 goes into a traditional IRA and $3,500 into a Roth IRA).

For the year an individual attains age 70½, and all years thereafter, contributions to traditional IRAs (deductible or nondeductible) are no longer permitted, even if the individual continues to have earned income. However, such a taxpayer's earned income can still be used by his or her spouse (under age 70½) as the basis for the spouse's IRA contributions. Taxpayers over age 70½ can still make contributions to Roth IRAs.

Spousal IRA

If a joint return is filed and the spouse's taxable compensation is less than the taxpayer's compensation, the maximum contribution is the smaller of:

1. $5,000; ($6,000 if age 50 or older); or
2. The total compensation for both the spouse and taxpayer reduced by the taxpayer's traditional or Roth IRA contribution.

IRA Contributions

Contributions must be made by the due date of the return **without extensions**. IRA contributions are deemed timely if postmarked by the due date. Members of the U.S. Armed Forces serving in a combat zone have until the extended due date.

The contribution can be claimed on the return as long as the contribution is made by the due date. IRA contributions, other than rollovers, must be made in cash.

No contribution to a traditional IRA is allowed for years during or after a year in which the taxpayer reaches age 70½. There are no age limitations for contributions to a Roth IRA.

Starting in 2007, all or part of a federal tax refund may be direct deposited into a qualifying IRA account (Pension Protection Act of 2006).

Except for a surviving spouse, no contributions are allowed to an inherited IRA (received on death of original owner).

A surviving spouse filing jointly with the decedent may contribute under spousal IRA rules up to the normal limit.

Traditional IRA and Deductibility

The allowable IRA deduction for an active pension plan participant is limited.

An individual is considered a plan participant (for the entire year) if, at any time during the year, the individual was employed where any of the following plans exist: a qualified pension, profit-sharing or stock bonus plan; Keogh plan; 401(k); union plan; qualified annuity plan; civil service plan; tax-sheltered annuity; SEP; IRC Sec. 501(c)(18) trust; or SIMPLE IRA.

An individual is active if:

1. **Eligible** to participate in a defined benefit plan, even if:
    a. Declines participation in plan;
    b. Fails to make mandatory contribution;
    c. Fails to meet minimum required service;
    d. Not aware of plan;
    e. Vesting is immaterial.

2. **Eligible** to participate in a defined contribution plan if:
    a. Employer or employee contributions or forfeitures added to account.
    b. Not active if only earnings are allocated to their accounts.

The employer is required to indicate active participation on the W-2.

Participation at any time during the year is considered participation for the entire year.

AGI LIMITS FOR TRADITIONAL IRA CONTRIBUTION FOR PLAN PARTICIPANTS		
Deductible IRA Phase-out	**2010**	**2011**
Joint Filer—Plan participants	$89,000–$109,000	$90,000-$110,000
Joint Filer – Not a plan participant married to a plan participant	$167-000-$177,000	$169,000-$179,000
Single, HOH plan participant	$56,000–$66,000	$56,000-$66,000
Married filing Separately lived with spouse during the year	$0–$10,000	$0-$10,000

Deduction for Nonplan Participants

For unmarried taxpayers who are not plan participants, deduction limits are not imposed.

For married taxpayers, neither of whom are plan participants, deduction limits are not imposed.

For married taxpayers filing jointly, with either spouse as a plan participant, there is a limit for the nonparticipatory spouse. Marital status is determined at year-end and the phase-out of the deduction for the individual (and not the spouse) in 2011 begins at $169,000. At $179,000, no deduction is allowed.

Example: Gary works full time at Thomson and contributes to the company's 401(k) plan. His wife Marina works seasonally at a tax preparation firm but is not eligible to participate in the retirement plan. Their joint AGI totals $145,000. Marina can contribute $5,000 to a deductible IRA but Gary cannot. His phase-out is based on the joint AGI limit (beginning at $90,000), as he is a plan participant.

Contributions to Nondeductible Contributory IRAs

The IRA contribution limit is $5,000 (plus catch-up) less the deductible IRA and Roth IRA contribution.

Even if otherwise deductible, the taxpayer can choose to designate the contribution as nondeductible.

Form 8606 (Nondeductible IRAs) is used to designate the amount of the nondeductible IRA. This form is required each year a nondeductible contribution is made; or, each year an IRA distribution is received when a nondeductible contribution had been made in prior years.

The taxpayer may make contributions to an IRA during the year and later determine that he/she is an active participant. The taxpayer may then choose to treat all or part of the contribution as nondeductible; or:

1. Withdraw the nondeductible portion of the contribution by the due date of the return (including extensions); or
2. If eligible, designate the contribution as a Roth IRA.

The taxpayer may change the choice by filing Form 1040X with Form 8606.

Nondeductible and deductible IRA contributions may be made to the same account.

The taxpayer has the responsibility to keep adequate records for both deductible and nondeductible contributions until the IRA is fully distributed.

A $100 penalty may be assessed to an individual who overstates nondeductible contributions on the return. Additionally, a $50 failure-to-file penalty is assessed if Form 8606 is omitted.

IRA Investments and Fees

IRA funds can be invested in anything the IRA trustee will allow except life insurance and certain collectibles (e.g., art, rugs, antiques, gems, stamps, etc.). Certain U.S. and state-issued gold, silver, and platinum coins and bullion are not considered collectibles and are allowed as IRA investments.

Trustee and investment fees are treated as miscellaneous itemized deductions if paid with funds outside the IRA account. However, amounts paid into the IRA to cover fees that, when combined with the contribution, exceed the $5,000 ($6,000 if age 50 or older) or 100% of compensation limitation are subject to the 6% excise tax on excess contributions. Fees paid with funds inside the IRA are not deductible.

Exposure of Assets Held in Traditional IRAs to Bankruptcy Creditors

Some account owners have worried that assets held in their IRAs might become exposed to creditors in the event of bankruptcy. This concern was reduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The law provides broad protection from bankruptcy creditors for IRAs—which include traditional and Roth IRAs, SIMPLE IRAs, and SEP IRAs. (Protection is also provided for assets held in qualified retirement plans, Section 403(b) plans, Section 457 plans, and Section 414 church and government plans.) For IRAs, the protection is generally limited to balances totaling $1 million (subject to adjustments for inflation). However, the $1 million ceiling is increased without limit for amounts rolled into IRAs from qualified retirement plans. These changes became effective on October 17, 2005.

To afford maximum protection from creditors, taxpayers should consider rolling amounts from a qualified plan into a totally separate rollover IRA, based upon the unlimited amount of protection given to such amounts under the 2005 Bankruptcy Act.

Roth IRA Contributions

A Roth IRA is simply an IRA designated as a Roth IRA when opened. Except as provided in IRC Sec. 408A, all the rules that apply to traditional IRAs apply to Roth IRAs.

Significant differences between traditional IRAs and Roth IRAs include the following: (1) Roth IRA contributions are never deductible; (2) Roth IRA contributions can be made beyond age 70½; (3) eligibility to contribute is based on different modified adjusted gross income (AGI) thresholds; (4) qualifying Roth IRA distributions are nontaxable; and (5) there is no requirement that distributions from Roth IRAs begin at age 70½. Traditional IRAs can be converted to Roth IRAs if certain conditions are met.

Contribution Limitations

Contributions to Roth IRAs are subject to the same dollar limitations as contributions to traditional IRAs. Thus, for 2011, an individual's contribution is limited to the lesser of (1) $5,000 ($6,000 if age 50 or older at year-end) or (2) 100% of the individual's compensation. For married couples filing joint returns, one spouse's earned income can provide the basis for the other spouse's contribution.

The total contributions to Roth IRAs and traditional IRAs cannot exceed the maximum annual contribution permitted to an IRA. For example, a taxpayer allowed a $5,000 IRA contribution can contribute that amount to either a traditional or Roth IRA, or part to each, but in no circumstances may the total combined contribution(s) exceed $5,000. Roth IRA rollovers or conversions do not affect allowable current year contributions to traditional or Roth IRAs.

Excess Roth contributions are subject to a 6% excise tax, unless timely corrective action is taken. When determining excess contributions, contributions to traditional IRAs are allowed before contributions to Roth IRAs. For example, a taxpayer who can contribute $5,000 to either a traditional or Roth IRA but contributes $5,000 to each is deemed to have made an allowable $5,000 contribution to the traditional IRA and an excess $5,000 contribution to the Roth IRA.

Once a taxpayer's maximum allowable Roth IRA contribution is determined, it is subject to phase-out based on the taxpayer's modified AGI. For high-income taxpayers, the phase-out can reduce or completely eliminate the amount an individual can contribute to a Roth IRA. The phase-out ranges are as follows:

	Phase-out Range (based on Modified AGI)	
Filing Status	**2010**	**2011**
Married filing joint return, qualifying widow(er)	$167,000–177,000	$169,000–179,000
Single, head of household	105,000–120,000	107,000–122,000
Married filing separate return	0–10,000	0–10,000

The phase-out amounts apply regardless of whether the individual (or spouse) is an active participant in an employer-sponsored retirement plan. The maximum contribution is reduced ratably when a taxpayer's modified AGI is within the phase-out range; when modified AGI exceeds the upper limit of the phase-out range, a Roth IRA contribution cannot be made. In applying the phase-out, the maximum amount is rounded to the next higher multiple of $10 and is not reduced below $200 until completely phased out.

Modified AGI is computed in the same manner as for limits on deductions for traditional IRA contributions, except income resulting from a Roth conversion is excluded.

Keogh and SEP Deductions for Self-employed Taxpayers

Contribution Limits

Self-employed taxpayers can adopt qualified retirement plans, normally referred to as Keogh plans. Keoghs are the unincorporated business's equivalent of corporate qualified retirement plans. They can also adopt simplified employee pensions (SEPs). SEPs are actually IRAs with higher funding limits that are established by an employer for the benefit of employees. For 2011, the contribution limit for profit-sharing, SEPs, and money purchase plans is the lesser of 25% of an employee's compensation (limited to $245,000) or $49,000.

SEPs and Keogh plans are required to cover all employees who meet certain minimum age and service requirements. For 2011, SEPs must cover all employees who (1) are at least age 21, (2) have worked for the employer for at least three of the five years immediately preceding the tax year, and (3) have received from the employer at least $550 in compensation in the tax year. Keogh plans are required to cover all employees who are at least age 21 and have at least one year of service (two years if the plan provides that after more than two years of service the employee has a nonforfeitable right to all of his or her accrued benefit). For both SEPs and Keoghs, an employer can adopt less restrictive coverage rules if desired. Thus, self-employed persons who employ others must consider the impact and potential cost of covering such employees when establishing a SEP or Keogh plan.

Compensation for a self-employed individual means earned income from the business that sponsors the plan. A self-employed individual's earned income is determined *after* the deduction for half of self-employment (SE) tax and *after* a reduction for the self-employed participant's deductible contribution to the SEP or Keogh plan. This latter reduction requires a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income).

Plan documents typically state contribution percentages in terms of an employee's compensation. However, as stated in the previous paragraph, an owner-employee's (i.e., self-employed taxpayer's) compensation must be reduced before the percentage can be applied. Alternatively, the percentage applicable to the owner-employee can be adjusted to consider these required compensation adjustments. Thus, the formula for determining the owner percentage when the employee percentage is known is:

$$\text{Owner \%} = \frac{\text{Employee \%}}{1 + \text{Employee \%}}$$

Using this formula, the owner's contribution percentage, based on various levels of contributions for employees, is computed as follows:

Employee's Contribution Percentage (% Contribution Based on Employee's Gross W-2 Income)	Owner's Contribution Percentage [% of Precontribution Net Self-employed Income (Net of Deduction for 50% of SE Tax)]
5%	4.7619%
10	9.0909
15	13.0435
20	16.6667
25	20.0000

In contrast, if the owner's desired contribution is known, the following formula is used to determine the employee percentage:

$$\text{Employee \%} = \frac{\text{Owner \%}}{1 - \text{Owner \%}}$$

Depending on the type(s) of plan, self-employed retirement plans can provide for any stated contribution rate from 1% – 25%. As a practical matter, most people have plans calling for discretionary contributions up to 25%, which results in a maximum applicable precontribution rate of 20% for the self-employed owner.

SEP and Keogh contributions made on behalf of employees are deducted on Schedule C (or F) on the line for "pension and profit-sharing plans." (Amounts contributed for employees are excludable from the employees' gross income.) Payments to SEPs and Keogh plans made on behalf of self-employed business owners are deducted on line 28 of Form 1040 as an adjustment to gross income. Defined benefit plan payments for the self-employed taxpayer should be identified as such by writing "DB" next to line 28 on Form 1040.

Adoption and Funding Deadlines

Keogh Plans. Keogh plans must be adopted before the end of the year to make deductible contributions after year-end. If a Keogh plan is adopted by December 31, deductible contributions can be made until the tax return due date, or if the return is extended, the extended due date of the Form 1040 (i.e., as late as October 15). In some cases, however, the qualified plan minimum funding rules (i.e., funding requirements for defined benefit and money-purchase plans) may require contributions be made no later than September 15, to avoid penalties for failure to make minimum funding contributions (*Wenger*). In addition, Form 5500 (or 5500-EZ) must be filed by July 31 of each year for calendar-year plans. However, certain one-participant plans with assets of $100,000 or less need not file returns.

SEP Plans. A SEP (unlike a Keogh) need not be established or funded until the tax return due date, including extensions. Therefore, the SEP offers a significant post-year-end tax planning opportunity for self-employed persons. Contributions made by the due date, including extensions, are treated as made on the last day of the tax return year. For example, a taxpayer may establish and fund a SEP plan on October 15, and claim the deduction on the prior year tax return if the tax return was extended to that date.

Example: Post-year-end contributions for a SEP.

Lisa starts a home-based business in 2011 and ends the year with Schedule C net income of $75,000. In March 2012, Lisa consults with her newly-hired CPA regarding preparation of her 2011 tax return.

Lisa should consider establishing a SEP. A self-employed individual can establish a SEP on or before the due date of their tax return (including extensions). Thus, Lisa has until October 15, 2012, to establish a SEP, make the appropriate contributions, and deduct the amounts on her 2011 tax return if her tax return is extended to that date.

A SEP generally is easy to adopt, and the rules governing participation are straightforward. For most employers, adopting a SEP means completing and signing Form 5305-SEP (Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement). The form is not filed with the IRS but is maintained as part of the employer's permanent records. In addition, a copy of the form (including the accompanying instructions) and a disclosure statement must be given to each employee covered by the SEP. Sponsoring employers must also give each participating employee an annual statement showing any contribution made to the employee's IRA. If the contribution is made before year-end, this last requirement is satisfied by reporting it on the employee's Form W-2. If the contribution is made after year-end (but before the employer's income tax return for the year is filed), notification should be given to each participating employee on a separate statement within 30 days of the contribution. In addition, employers generally need not file the Form 5500 series for the SEP.

A SEP is funded by having each eligible employee set up an IRA with a qualified IRA sponsor (e.g., a bank, an insurance company, or a mutual fund). The employer then makes contributions directly to the employee's IRA. SEP contributions can be made to an employee's or self-employed individual's existing traditional IRA in lieu of establishing a separate IRA for the SEP contributions.

Employer-sponsored SIMPLE IRAs

A savings incentive match plan for employees (SIMPLE IRA plan) is a written salary reduction arrangement under which an eligible employee can elect to have the employer make contributions to a SIMPLE IRA rather than receiving that amount in cash. An employer that establishes a SIMPLE IRA plan must make either matching contributions or nonelective contributions.

SIMPLE IRAs are available to employers with 100 or fewer employees receiving at least $5,000 of compensation in the prior calendar year. Self-employed individuals are also eligible to participate in a SIMPLE IRA plan. The employer may not currently maintain any other qualified retirement plans while using a SIMPLE IRA plan.

SIMPLE 401(k) plans are also available to the same employers who can establish SIMPLE IRA plans. A SIMPLE 401(k) plan is a qualified plan (profit-sharing plan) and is subject to the same requirements as Keogh plans. The main advantage of SIMPLE 401(k) plans over typical 401(k) plans is that they are subject to simplified nondiscrimination tests and they are not subject to the top-heavy rules.

If an employer establishes a SIMPLE IRA plan, all employees who received at least $5,000 in compensation from the employer during *any* two prior tax years (whether or not consecutive) and who are reasonably expected to receive at least $5,000 in compensation during the current year must be eligible to participate in the plan for the year. The employer can provide more liberal participation requirements than these, but not more restrictive ones. For example, an employer could allow employees to begin participating as soon as they are employed. This enables employers, including self-employed individuals, to establish SIMPLE IRA plans in their first year of existence without regard to any compensation requirement for prior years.

An advantage of SIMPLE IRA plans is that they are easier to operate than Keogh plans. SIMPLE IRA plans do not have to meet the nondiscrimination requirements, minimum participation and minimum coverage rules, vesting rules, or the top-heavy rules applicable to qualified plans.

Contribution and Eligibility Rules

SIMPLE IRA plans allow employee elective contributions and require employer matching contributions or nonelective contributions. For 2010 and 2011, employee elective contributions are limited to the lesser of (1) the employee's compensation or (2) $11,500 ($14,000 if age 50 or older). Employer contributions must be made under one of two formulas:

1. **Matching Contribution Formula.** Employers must generally match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year. However, in two out of every five years, the employer has the option of electing a matching percentage as low as 1% of each eligible employee's compensation. For purposes of the matching contribution, compensation is not limited.
2. **Nonelective Contribution Formula.** In lieu of making matching contributions, the employer may contribute 2% of compensation for each eligible employee having at least $5,000 of compensation during the calendar year. For purposes of this formula, compensation of each eligible participant is limited to the Section 401(a)(17) limit ($245,000 for 2011), thus limiting the contribution to no more than $4,600 per employee.

There is a limit as to total amount of compensation an individual can elect to defer each year. This aggregate limit applies to all elective deferrals the individual makes to 401(k) plans, 403(b) plans, SARSEPs, as well as SIMPLE IRA plans for the year regardless of whether the plans are provided by related or unrelated employers. For 2011, an employee's aggregate elective deferral limit is $16,500 ($22,000 if age 50 or older).

Example: Computing the elective deferral limit for a SIMPLE IRA.

Jane, age 40, is a participant in LMN Corp.'s 401(k) plan under which she elected to defer $9,000 during 2011. She has no ownership in LMN Corp. During 2011, Jane earned $11,000 in directors' fees from Snakes, Inc., which is not related to LMN Corp. This $11,000 will be reported as self-employment (SE) income (sole proprietorship) on Jane's 2011 return and she would like to establish a SIMPLE IRA plan on behalf of this business. If she does so, how much can she elect to defer under the plan for 2011?

Jane's aggregate elective deferral limit for 2011 is $16,500. Therefore, her elective deferral limit for the SIMPLE IRA is $7,500 [$16,500 aggregate elective deferral limit – $9,000 elective deferral made to the 401(k) plan].

Example: Computing the elective deferral limit for a SIMPLE IRA (continued).

Variation: What if Jane had deferred $2,000 (rather than $9,000) to the 401(k) plan?

Jane's remaining aggregate elective deferral limit would be $14,500 [$16,500 aggregate elective deferral limit – $2,000 elective deferral made to the 401(k) plan]. However, the elective deferral to the SIMPLE IRA plan would be further limited to $11,000, the lesser of 100% of her compensation from the sole proprietorship ($11,000) or the SIMPLE IRA elective deferral limit ($11,500).

Deferrals in excess of the aggregate elective deferral limit (excess deferrals) are included in the employee's income in the year the deferral was made.

Employers cannot deny participation to employees who reach age 70½. The rule that prohibits traditional IRA contributions after a taxpayer turns 70½ does not apply to SIMPLE IRA plan contributions.

Employees are not taxed currently on any contributions made to the plan or on any earnings in their accounts. Employer matching or nonelective contributions to SIMPLE IRAs are not treated as wages for employment tax purposes (i.e., are not subject to payroll taxes). (Employee elective contributions are, however, subject to payroll taxes.)

Distributions from SIMPLE IRA plans generally are taxed under the rules applicable to traditional IRAs. Tax-free rollovers can be made from one SIMPLE IRA to another. A SIMPLE IRA can be rolled over to another eligible retirement plan (i.e., qualified plan, traditional IRA, 403(b) plan, or governmental 457 plan) on a tax-free basis only after the participant has been in the plan for two years. If an employee terminates employment and two years have expired since the employee first participated in the SIMPLE IRA plan, the employee's SIMPLE IRA is treated as a traditional IRA.

Early withdrawals from a SIMPLE IRA generally are subject to the 10% early distribution penalty tax applicable to IRAs. However, if the participant receives a distribution before being in the plan for two years, a 25% early withdrawal tax applies (rather than 10%).

Compensation

For the rules relating to SIMPLE IRA plans, compensation means compensation required to be reported by the employer on Form W-2, plus any elective deferrals made by the employee under a 401(k), 403(b), SARSEP, or SIMPLE IRA plan sponsored by the employer. For a self-employed individual, compensation means net earnings from self-employment as defined by IRC Sec. 1402(a)(12) without regard to the self-employed person's SIMPLE IRA plan contribution.

When and Where Contributions Are Deductible

SIMPLE IRA contributions made on behalf of employees are deducted on Schedule C (or F) on the line for "pension and profit-sharing plans." Payments made on behalf of the self-employed business owner are deducted on line 28 of Form 1040 as an adjustment to gross income.

Employee elective deferrals must be deposited to the employee's SIMPLE IRA as soon as reasonably possible, but in no case later than 30 days after the end of the month to which the contributions relate.

Establishing SIMPLE IRA Plans

An employer can generally establish a SIMPLE IRA plan effective on any date between January 1 and October 1 of the year. However, if an employer (or predecessor employer) previously maintained a SIMPLE IRA plan, a new SIMPLE IRA plan can be established effective only on January 1. Also, a new employer that comes into existence after October 1 can establish a SIMPLE IRA plan effective between October 1 and December 31 if the plan is established as soon as administratively feasible after the employer comes into existence.

Deducting Moving Expenses

Certain expenses incurred in moving to a new principal residence are deductible if the move is job related. These expenses are deductible "above the line" in computing adjusted gross income. Moving expenses (for both foreign and domestic moves) are first reported on Form 3903 (Moving Expenses). The total deductible expense is then carried to line 26 of Form 1040 as an adjustment to gross income.

Deductible Moving Expenses

The following expenses are deductible if the move is job-related (see discussion later in this section):

1. The cost of transporting household goods and personal effects from the former residence to the new residence. This includes the cost to pack and crate, store, and insure household goods and personal effects within any period of 30 days in a row after they were moved from the taxpayer's old home and before they were delivered to the new home.
2. The cost of traveling from the former residence to the new residence. (Traveling expenses include lodging but not meals.)

For 2011, automobile expenses can be calculated at $.19 per mile in lieu of actual expenses.

Nondeductible Moving Expenses

Moving expenses other than those specifically allowed as deductions are not deductible. Common nondeductible moving expenses include:

- Meals while moving from an old residence to a new residence.
- Travel expenses, meals, and lodging for a pre-move house-hunting trip.
- Meals and lodging while occupying temporary quarters in the area of the new job.
- Expenses of buying or selling a home or of getting or breaking a lease.

Move Must Be Job-related

For moving expenses to be deductible, the move must be job related. A move is job related if the taxpayer meets two tests—(1) the time test and (2) the distance test. The time test requires the taxpayer to be employed full-time in the general location of the move for at least 39 weeks during the 12-month period following arrival at the new location. Employment need not be with

same employer. A self-employed taxpayer must work full-time (at his own business or as an employee) for at least 39 weeks during the first 12 months and for at least 78 weeks during the 24-month period following the move. The distance test generally requires the new principal place of work to be at least 50 miles farther from a taxpayer's former home than his former principal place of work. (In other words, had the taxpayer not moved, commuting to the new work location would have increased his commute by 50 miles or more when compared to the commute to the prior workplace.)

Employer Reimbursements of Moving Expenses

Employer-paid moving expenses paid to the employee are reported on the employee's Form W-2. Employers handle employee moving expenses as follows: (1) deductible moving expenses paid by the employer to a third party or provided by the employer in-kind are not reported on Form W-2, (2) deductible moving expense reimbursements the employer pays directly to the employee are reported in box 12 of Form W-2 and identified with Code P, and (3) employer reimbursements for nondeductible moving expenses are included in the employee's taxable wages reported in box 1 of Form W-2.

When an employee is reimbursed for deductible moving expenses (i.e., shown with Code P in box 12 of Form W-2), the reimbursement is reported on Form 3903 along with all deductible moving expenses the employee incurred. If deductible moving expenses exceed the employer reimbursement, the excess is carried to and deducted on line 26 of Form 1040. If reimbursed moving expenses exceed actual deductible expenses incurred, the excess is carried from Form W-2 to line 7 of Form 1040 and reported as additional taxable wages.

Reimbursement Received and Expenses Paid in Different Tax Years

Generally, cash-basis taxpayers deduct moving expenses in the year paid, but often the reimbursement is received in the preceding or following year. If this occurs, the taxpayer can choose to deduct the expenses in the year of reimbursement if (1) the expenses were paid in a year before the year of reimbursement, or (2) the expenses were paid in the year immediately after the year of reimbursement but on or before the due date (including extensions) for filing the tax return for the year of the reimbursement. By reporting deductions in the year of reimbursement, taxpayers can avoid prepaying tax on the reimbursement income by matching revenues and expenses in the year incurred.

A taxpayer who wants to deduct moving expenses in the year of reimbursement simply deducts them in that year. No special attachments or statements are required to document the election.

Self-employed Health Insurance Deduction

Self-employed taxpayers are allowed an "above-the-line" deduction for 100% of the cost of providing medical, dental, and qualifying long-term care insurance for themselves and their families. (The amount is deducted on page 1 of Form 1040 as an adjustment to income.) Although the deduction reduces adjusted gross income (AGI), it is not allowed as an expense when calculating net earnings subject to self-employment (SE) tax.

In 2010, self-employed health insurance premiums also reduced SE tax calculated on Schedule SE. Under current tax law, this was only for 2010.

The following special rules apply in that the deduction can only be claimed:

1. For calendar months when the self-employed taxpayer is not eligible to participate in a subsidized health plan maintained by any employer of either the taxpayer or the taxpayer's spouse;

   This rule applies separately to employer health plans that include long-term care coverage and ones that do not. Taxpayers eligible to participate in an employer plan that does not include long-term care coverage can deduct the applicable percentage of their own long-term care policy in computing AGI.

2. Only if the medical insurance plan is established by the taxpayer's business and only to the extent of the taxpayer's earned income from that business; and

   The medical insurance plan established with respect to the taxpayer's specific business can be purchased in the individual's name.

3. For long-term care insurance premiums only if the policy is a "qualified" contract and subject to the limits in the following table.

Age before the End of the Tax Year	Limit on Deduction for Premiums Paid	
	2010	**2011**
Age 40 or under	$ 330	$ 340
Age 41–50	620	640
Age 51–60	1,230	1,270
Age 61–70	3,290	3,390
Over age 70	4,110	4,240

Health insurance premiums paid on behalf of the sole proprietor, spouse, and dependents are deducted on line 29 of Form 1040 as an adjustment to income.

The deduction is limited to the net profit from Schedule C minus the deductions for one-half of SE tax, and for contributions for the sole proprietor's benefit to a SEP, SIMPLE or qualified plan. Do not include any amount deducted on line 29 of Form 1040 in figuring the medical expense deduction on Schedule A (Form 1040).

The deduction is not allowed for any month that the self-employed individual or the spouse is eligible to participate in a subsidized health plan maintained by an employer.

According to a 1995 advice from the IRS Chief Counsel's Office, Medicare Part B premiums are not considered medical insurance premiums for the SE health insurance deduction.

Distinguishing Alimony from Nondeductible Payments

Payments properly classified as alimony are deducted above the line on the payer's return.

Alimony (IRC Sec. 71)

The tax code states that alimony payments are deductible by the payer in the year paid and includible by the payee when determining taxable income. However, merely specifying payments from one to the other as alimony is not enough (*Zinsmeister, Alan Robert)*.

A payment qualifies as alimony only if all seven of the following requirements are met:

1. Payments are made under a written instrument of divorce or separation.
2. Payments are made in the form of cash, check, or money order made out directly to the former spouse or to a third party specified by the former spouse in writing as eligible to receive the payment.
3. Payments must terminate upon death of the recipient. However, the divorce instrument no longer has to expressly state that the payments cease upon death if the liability would end under state law (*Kean v. Comm*.).
4. The divorcing spouses must not live together (i.e., not be members of the same household). Physical separation in the same residence (different rooms, east wing versus west wing) is not enough. However, if one spouse is preparing to leave at the time the payment is made and the departure actually occurs within one month after the payment date, a physical separation is deemed to have occurred.
5. If the divorcing couple is not legally separated under a decree of divorce or separate maintenance, payments under a written separation agreement or temporary support order may qualify as alimony, even if the couple remains within the same household.
6. Payments are not fixed as child support nor do they give the appearance of relating to a child's support.
7. The parties have not designated in writing as excluded from alimony treatment.
    a. A divorcing couple can elect out of alimony treatment simply by stating in the applicable agreement or decree that the payments are not alimony for tax purposes.
    b. Such an agreement should specify which payments are not to be treated as alimony and expressly state that they are not deductible by the paying spouse and are excludable from gross income by the receiving spouse.
    c. The receiving spouse must attach a copy of the *not-alimony* designation to the original return for each year that *not-alimony* payments are received.
8. The parties do not file a joint return with each other for the year in which the qualifying payment is made.

Other Payments

Common payments made to third parties and treated as alimony include medical expenses, rent, mortgage payments, property taxes, insurance, utilities, etc., if paid on behalf of or for the benefit of the other spouse. In order to qualify as alimony, the payer spouse must not derive a benefit from the payment (other than for compliance with the divorce instrument). For examples, see the following table.

Payments	Alimony?
Paying spouse pays the mortgage and property taxes on a house he/she owns but is occupied by the payee spouse.	No
Paying spouse must pay payee spouse's medical bills.	Yes
Paying spouse pays life insurance premiums in a policy that names the receiving spouse as the owner.	Yes
Paying spouse pays life insurance premiums in a policy that names the receiving spouse as the beneficiary but keeps the paying spouse's name as the policy's owner.	No

Deducting Interest Paid on Education Loans

Individuals who have taken out loans to pay the cost of attending an eligible higher educational institution for themselves, their spouses, or their dependents generally may deduct the interest they pay, subject to certain limitations and restrictions. The deduction is claimed in computing adjusted gross income (AGI) (i.e., "above-the-line"); so a taxpayer need not itemize to benefit.

Maximum Allowable Deduction

The maximum amount a taxpayer is permitted to deduct is $2,500. The limitation is the same regardless of how many students are in the taxpayer's family. Only the taxpayer legally obligated to make interest payments under the terms of the qualified education loan can claim the interest deduction.

The maximum allowable deduction phases out ratably when a taxpayer's modified AGI exceeds certain amounts. Modified AGI is AGI before the deductions for education loan interest, qualified tuition and expenses, and domestic production activities, and before the exclusions for (1) foreign earned income and housing costs, and (2) income from certain U.S. possessions and Puerto Rico. For 2011, the deduction phases out ratably as modified AGI moves from $120,000–$150,000 for married joint filers and $60,000–$75,000 for single and head of household filers. Married taxpayers must file a joint return to claim a deduction.

Other Considerations

Qualified Education Loan. Qualified education loans are loans taken out solely to pay qualified education expenses, including tuition, fees, room and board, books, equipment and transportation to attend an eligible educational institution.

Coordination with other Education Benefits. Qualified education expenses must be reduced by any paid with nontaxable education benefits received, such as employer-provided

educational assistance, nontaxable distributions from an ESA or QTP, Series EE bond interest education exclusion or veteran's educational benefits.

Eligible Educational Institutions include colleges, vocational schools and other postsecondary institutions that are eligible to participate in Department of Education student aid programs.

Eligible Student. Students must take at least one half the normal full-time load in a degree, certificate or other qualified program at an eligible institution.

Restrictions

The following restrictions apply to the student loan interest deduction.

1. The deduction is not available to a taxpayer when a dependency exemption deduction for that person is allowed to another taxpayer.
2. The deduction is not available to married taxpayers filing separately.
3. A taxpayer must have primary obligation to repay the loan in order to deduct the interest and actually pay the interest during the tax year.
4. Interest on a loan from a related person does not qualify. Related persons include: siblings, spouses, ancestors (parents, grandparents, etc.) and lineal descendants, as well as certain corporations, partnerships, trusts and exempt organizations.
5. Loans from a qualified employer plan [for example, 401(k) plan] do not qualify.

Because of the first and third restrictions, a student loan interest deduction often will not be allowed when the student takes out the loan and his parents claim a dependency deduction for the student/child. *Reason:* If the student has the primary obligation to repay, his parents cannot deduct any interest they pay. Alternatively, if the student pays interest on the loan, he cannot deduct the interest if his parents claim a dependency exemption deduction for him. A point to consider in this situation is that even if a dependency exemption deduction is allowed to the parents for the student/child, it may make sense for the student/child to take out the loan when payments will not be due until after graduation, at which point the child will likely no longer be a dependent and can therefore, deduct the interest on his return.

Tuition and Fees Deduction

Under IRC Sec. 222, an above-the-line deduction is allowed, within limits, for "qualified tuition and related expenses," as defined under the Hope and Lifetime Learning credit rules of IRC Sec. 25A(f)(1). The deduction is claimed on Form 8917 (Tuition and Fees Deduction) and is then carried to Form 1040, page 1.

This provision has been extended through 2011 by the Tax Relief Act of 2010.

No Deduction if American Opportunity Tax Credit (formally Hope) or Lifetime Learning Credit Is Claimed

Taxpayers are not eligible to claim a tuition deduction and an American Opportunity Tax Credit (formally Hope) or Lifetime Learning Credit in the same year for the same student.

No Deduction for Amounts Excludable Due to ESA and Other Distributions

The deduction cannot be claimed for expenses that were paid with tax-free withdrawals from Education Savings Accounts, tax-free withdrawals from 529 Plans, or excluded interest from Education Savings Bonds.

Educator's Expense Deduction

For 2011, an eligible educator is allowed an above-the-line deduction for up to $250 for classroom expenses paid during the tax year. Eligible expenses include books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment and supplementary materials used by the educator in the classroom. These expenses must meet the definition of IRC Sec. 162 ordinary and necessary employee business expenses. The deduction is claimed on page 1 of Form 1040.

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a K–12 school for at least 900 hours during a school year.

Taxpayers filing joint returns who are both eligible educators are each eligible for the $250 deduction, for a total of $500 on the return. However, neither spouse can deduct more than $250 of his or her own expenses.

The school year is used in determining if an individual meets the 900-hour requirement for defining an eligible educator, whereas the $250 deduction is for expenses paid during the tax year. Because a school year spans two tax years, an individual who qualifies as an eligible educator for either the 2009–2010 or 2010–2011 school year is eligible for the deduction for both the 2010 and 2011 tax year.

The statute also provides that expenses are allowed only to the extent they were not otherwise reimbursed via a tax-free withdrawal from a Section 529 qualified tuition plan, a Section 530 Coverdell Education Savings Account, or a Section 135 tax-free U.S. savings bond redemption. This provision appears to be overkill, as an educator's personal continuing education expenses that might be reimbursed under any of these three arrangements are unlikely to overlap with the definition of eligible K–12 classroom materials and supplies.

Example: Teacher's deduction for classroom expenses.

Seth, age 25 and single, is a seventh grade history teacher. During 2011, he incurs $300 for supplemental classroom materials and supplies that are not reimbursed by his employer. Seth can deduct $250. If Seth's marginal federal rate is 15%, this saves $38; if his marginal federal rate is 25%, the savings are $63.

Deducting Contributions to Health Savings Accounts

A health savings account (HSA) is a tax-exempt trust or custodial account established exclusively for the purpose of paying qualified medical expenses of the account beneficiary who, for the months for which contributions are made to an HSA, is covered under a high-deductible health plan (HDHP).

A taxpayer is not required to use distributions from an HSA for medical expenses; however, distributions are taxable and a 10% penalty may apply if they are used for expenses other than qualified medical expenses and received before the taxpayer reaches age 65.

The HSA is used in conjunction with an HDHP. An HDHP does not cover “first dollar” medical expenses (except for certain preventive care).

Contributions into the HSA are pre-tax. If made by an employer on behalf of the employee, the contributions are not included in income. If made by the employee, the contributions are an “above-the-line” adjustment on the employee’s 1040 tax return.

Distributions from an HSA to pay qualified medical expenses are not taxable. Nonqualified distributions are taxable and generally subject to a 10% penalty until age 65.

Eligibility for an HSA

In general, eligible individuals do not have access to full coverage health plans. This would include self-employed, unemployed, small business owners and small-firm employers.

An individual eligible for an HSA **must be**:

1. Covered by a High-Deductible Health Plan (HDHP);
2. Not enrolled in Medicare Part A or B;
3. Not claimed as a dependent; and
4. Not covered by other health insurance, excluding “permitted insurance” and “permitted coverage.”

The following coverage is permitted (whether through insurance or otherwise):

1. Accidents, disability, dental, vision, long-term care, specified disease or illness.
2. Employee assistance programs, disease management programs or wellness programs, these programs however must not provide significant benefits in the nature of medical care or treatment.
3. Drug discount cards.
4. Eligibility for VA benefits, unless individual has actually received VA health benefits within the last three months.

The following “first-dollar” medical benefits are **not** permitted:

1. Medicare
2. Medicaid
3. TRICARE (health care program for military, family and survivors)
4. Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs) (with exceptions)
5. Coverage under a spouse’s plan, including: low-deductible insurance coverage, FSA or HRA through spouse’s employer

High-deductible Health Plan (HDHP)

An HDHP must require a **minimum deductible** amount and a **maximum annual out-of-pocket** amount.

Deductible and Out-of-Pocket Limits				
	2010		2011	
	Minimum Deductible	Maximum Out-of-Pocket	Minimum Deductible	Maximum Out-of-Pocket
Single	$1,200	$5,950	$1,200	$5,950
Family	$2,400	$11,900	$2,400	$11,900

Out-of-pocket costs are the amounts the individual must pay for qualified medical expenses charged against the deductible, co-payments (even if not applied to the deductible) and other amounts. Applies only to "covered benefits." Generally, insurance premiums are **not** included.

An HDHP must apply costs of prescription drugs to the annual deductible or the plan does not qualify as an HDHP.

Preventive Care. There is no requirement that an HDHP must cover preventive care or provide preventive care with a deductible below the minimum deductible. However, a safe harbor provision (Notice 2004-23) **allows** an HDHP to provide certain preventive care benefits without a deductible or with a lower deductible amount than the HDHP minimum.

Contributions

1. The maximum annual contribution is no longer limited to the annual HDHP plan deductible and only has a maximum plan limit once a qualified insurance plan is in place.

2. The maximum annual contribution is:

Maximum Contribution Limits		
	2010	2011
Single	$3,050	$3,050
Family	$6,150	$6,150
Age 55-64 Catch Up	$1,000	$1,000

3. Limits must be aggregated with other HSAs and MSAs.

4. Contributions must stop on the first month **enrolled** in Medicare.

Provisions for Individuals Age 55 and Older

If age 55 or older by December 31, the individual is eligible for the additional catch-up contribution amount. It does not matter when birthday falls during the year.

If both spouses are 55 or older, and both want to make catch up contributions, each spouse must have individual, separate HSAs.

Catch-up Contributions	
2010	2011
$1,000	$1,000

Anyone may contribute to an HSA on behalf of an eligible individual; however, the aggregate contributions from all sources must not exceed the maximum allowable contribution for the eligible individual.

Excess contributions not removed by the return due date (including extensions) are subject to a 6% excess contributions penalty.

Rollovers

Rollover contributions from MSAs and other HSAs into an HSA are permitted. They must be completed within 60 days after the day on which the beneficiary receives the payment or distribution and only one rollover from an HSA to another HSA is allowed within a one-year period ending on the day of such receipt.

In addition, at any time before January 1, 2012, a taxpayer may make one tax-free rollover from an IRA (that would be otherwise taxable when distributed) to an HSA and one tax-free rollover from a flexible spending account (FSA) or health reimbursement arrangement (HRA) to an HSA. The rollover contribution from an IRA may not exceed the taxpayer's maximum HSA contribution for the year. The rollover contribution from an FSA or HRA may not exceed the lesser of the balance in such arrangement on September 21, 2006 or on the date of the rollover distribution. The rollover must be made directly to the HSA by the IRA trustee or the taxpayer's employer. The taxpayer must remain eligible for an HSA until the last day of the twelfth month following the rollover or the distribution will be includable in income and subject to a 10% penalty tax. Rollover contributions are nondeductible. Rollovers from FSAs or HRAs do not affect the employee's or the employer's ability to make regular deductible contributions to the employee's HSA. However, IRA rollover contributions do reduce an individual's deductible HSA contribution maximum for the year of the rollover.

IRS Notice 2007-22 provides guidance regarding the rules. According to this notice, by plan year-end, the plan must be amended to provide for such rollovers, the employee must elect the rollover, and the year-end balance must be frozen. In addition, the funds must be transferred by the employer within 2½ months after plan year-end and result in a zero balance in the health FSA or HRA. The IRS expects to provide additional guidance at a later date. Practitioners should be alert for such new guidance.

Example: Rollover from an FSA to an HSA.

For 2011, Abernathy, Inc. has a calendar year general purpose health FSA with a grace period ending March 15, 2012. Before January 1, 2012, Abernathy amended the health FSA to allow for qualified HSA distributions, allowing employees with HDHP coverage to elect to have any health FSA balance at year-end, determined on a cash basis, contributed directly to an HSA trustee for the employee. If the employee elects the qualified HSA distribution, he or she cannot submit any additional claims after December 31, 2011, regardless of when the expense was incurred, nor will any pending claims submitted before December 31, 2011, be paid after December 31, 2011. Rather, the entire balance will be distributed to the employee's HSA.

Albert White, an employee of Abernathy, Inc., has a balance of $960 in his health FSA on September 21, 2010, and a balance of $700 on December 31, 2011. He elects HDHP coverage beginning January 1, 2012, and also elects to have a qualified HSA distribution from his 2011 FSA. He submitted a claim for $200 to the FSA on December 19, 2011, but it was not processed and paid by December 31, 2011.

Since Abernathy amended the plan by plan year-end and Albert elected the HSA distribution, the plan was frozen on December 31, 2011. As such, the $200 claim submitted on December 19, 2011, will not be paid. Before March 15, 2012, Abernathy must distribute $700 (the amount frozen in Albert's FSA account at plan year-end) into Albert's HSA. Since Albert elected HDHP coverage beginning January 1, 2012, he is an eligible individual to receive the FSA distribution into his HSA.

IRS Notice 2007-22 also provides guidance and examples on the consequences of failing to meet the conditions to be a qualified rollover. If the entire FSA is not frozen and distributed to the HSA, the employee will not be an eligible individual as of the beginning of the plan year (typically January 1) but will remain an ineligible employee until the 2½ month grace period has expired. Because the employee is ineligible, the HSA distribution will become taxable income to the employee in the year of distribution and be subject to a 10% penalty tax.

Chapter 7 Exercises

Question 1: Allowable Roth IRA contribution.

Part 1: Lois, a single person, age 45, has 2011 salary income of $102,500 and modified AGI of $112,500 (which puts her halfway through the Roth IRA phase-out range of $107,000 to $122,000). How much can she contribute to a Roth IRA in 2011?

Part 2: Assume that Lois is an active participant in an employer-sponsored retirement plan. How much can she contribute to her Roth IRA for the year?

Part 3: Assume now that Lois is **not** an active participant in an employer-sponsored retirement plan. How much can she contribute to her Roth IRA?

Question 2: Alimony.

Part 1: Subsequent to Bill and Mary Ann deciding to divorce, Bill moves into a separate apartment. Bill moved out on April 1, 2011, but the written separation agreement—which orders Bill to pay Mary Ann $1,000 per month—did not take place until August 1, 2011. Bill paid Mary Ann $1,500 per month from April 2011 through December 2011. How much can Bill deduct as alimony in 2011?

Part 2: Assume that Bill and Mary Ann have been divorced for several years. Although Bill is required to pay Mary Ann $1,000 per month, he has fallen on hard times. For 2011, he provides Mary Ann with $8,000 in checks and a promissory note for $4,000 at 10% interest. How much can Bill deduct as alimony in 2011?

Part 3: Assume now that, as part of the divorce settlement, Bill is required to pay his ex-wife, Mary Ann, $12,000 per year for 12 years, or until Mary Ann's death, whichever occurs first. But, if Mary Ann dies before the 12th year, Bill is ordered to pay Mary Ann's estate any unpaid amounts. Bill pays Mary Ann $12,000 in 2011. How much can Bill deduct as alimony in 2011?

Chapter 7 Exercise Solutions

Question 1: Allowable Roth IRA contribution.

Part 1: Lois, a single person, age 45, has 2011 salary income of $102,500 and modified AGI of $112,500 (which puts her halfway through the Roth IRA phase-out range of $107,000 to $122,000). How much can she contribute to a Roth IRA in 2011?

Answer: *Her maximum allowable IRA contribution is $5,000. However, her Roth IRA contribution is limited because her modified AGI exceeds $107,000. Her maximum allowable Roth IRA contribution is $3,167 [$5,000 × ($122,000 – $112,500) ÷ $15,000].*

Part 2: Assume that Lois is an active participant in an employer-sponsored retirement plan. How much can she contribute to her Roth IRA for the year?

Answer: *Lois can still contribute up to $5,000 to an IRA in 2011. However, her Roth IRA contribution is limited to $3,167 and contributions to traditional IRAs are not deductible (because she is an active participant in an employer-sponsored plan and her modified AGI exceeds $65,000).*

Part 3: Assume now that Lois is **not** an active participant in an employer-sponsored retirement plan. How much can she contribute to her Roth IRA?

Answer: *Lois is still limited to a $3,167 contribution to her Roth IRA. However, because she is not an active participant in an employer plan, Lois is entitled to contribute and deduct the maximum amount ($5,000) to a traditional IRA. If she does contribute $3,167 to a Roth IRA, the maximum amount she can contribute to a traditional IRA is $1,833 (for total IRA contributions of $5,000). Lois can contribute to her Roth and traditional IRAs in any combination she desires, provided her combined contributions do not exceed $5,000 and her Roth contribution does not exceed $3,167.*

As the preceding paragraph illustrates, there may be cases when an individual's maximum allowable IRA contribution (generally $5,000) cannot be made entirely to one type of IRA (e.g., traditional deductible or Roth), but it can still be made by allocating it between different types of IRAs. The first step is to determine a client's maximum allowable IRA contribution (i.e., for 2011, the lesser of $5,000/$6,000 or compensation). Then, determine which types of IRAs (i.e., traditional deductible, traditional nondeductible, or Roth) the client can contribute to and the limitations, if any, on each.

Question 2: Alimony.

Part 1: Subsequent to Bill and Mary Ann deciding to divorce, Bill moves into a separate apartment. Bill moved out on April 1, 2011, but the written separation agreement—which orders Bill to pay Mary Ann $1,000 per month—did not take place until August 1, 2011. Bill paid Mary Ann $1,500 per month from April 2011 through December 2011. How much can Bill deduct as alimony in 2011?

Answer: *Bill will be allowed to deduct $5,000 as alimony. Although Bill paid Mary Ann a total of $12,000 ($1,500 × 8 months), the written separation agreement specified $1,000 payments as alimony from August through December. Thus, the extra $7,000 does not qualify as alimony.*

Part 2: Assume that Bill and Mary Ann have been divorced for several years. Although Bill is required to pay Mary Ann $1,000 per month, he has fallen on hard times. For 2011, he provides Mary Ann with $8,000 in checks and a promissory note for $4,000 at 10% interest. How much can Bill deduct as alimony in 2011?

Answer: *Bill can deduct only the $8,000 paid in cash as alimony. The promissory note does not qualify as alimony until it is paid in cash.*

Part 3: Assume now that, as part of the divorce settlement, Bill is required to pay his ex-wife, Mary Ann, $12,000 per year for 12 years, or until Mary Ann's death, whichever occurs first. But, if Mary Ann dies before the 12th year, Bill is ordered to pay Mary Ann's estate any unpaid amounts. Bill pays Mary Ann $12,000 in 2011. How much can Bill deduct as alimony in 2011?

Answer: *Bill is not entitled to an alimony deduction. Because Bill's liability to pay extends to MaryAnn's estate upon her death, none of the payments Bill makes qualifies as alimony.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. Pam (age 36) works full time earning $95,000 and participates in her employer's 401(k) program. Her spouse Jim (age 32), earns $25,000 but his company offers no qualified plan for him to participate in. How much can each deduct for a contribution into a traditional IRA?

    a. In 2011, only Jim may contribute and deduct up to $5,000.

    b. In 2011, neither may make a deductible contribution; however, they could contribute to a nondeductible IRA or Roth IRA.

25. All taxpayers are entitled to contribute to which of the following?

    a. A nondeductible traditional IRA.

    b. A nondeductible traditional IRA or a Roth IRA.

    c. A deductible or nondeductible traditional IRA.

26. Which of the following statements is true regarding Roth IRA contributions?

    a. Roth IRA contributions reduce adjusted gross income.

    b. Roth IRA distributions are not required to begin at age 70½.

27. Deductible moving expenses include which of the following?

    a. Transportation from the former residence to the new residence, temporary housing, and expenses incurred to sell a principal residence.

    b. Transportation and the cost of transporting household goods from the former residence to the new residence due to a job transfer.

    c. All expenses incurred due to the relocation of the taxpayer.

    d. Moving expenses are not deductible but may be excludible.

28. Roger is self-employed and single. To qualify for the deduction for health insurance (for AGI), he or his policy must:

    a. Not be eligible for coverage by another subsidized plan.

    b. Meet the definition of a high-deductible insurance plan and have earnings under $150,000.

29. Mary and Barry divorced in 2011. Barry is required to pay Mary $1,000 per month for the rest of her life, with payments ceasing upon her death. Barry paid Mary 10 months in 2011. What amount can Barry deduct as alimony in 2011?

    a. Unable to determine as payments may be child support if they have a child and the child lives with Mary.

    b. $12,000.

    c. $10,000.

    d. Unable to determine as payments may be subject to recharacterization as property settlement payments.

30. When are contributions to a Health Savings Account deductible?

    a. When the policy meets the definition of a high-deductible plan and the taxpayer is not eligible for coverage by another subsidized plan.

    b. When the policy meets the definition of a high-deductible insurance plan and the participant has earnings under $150,000.

    c. The taxpayer must not be eligible for coverage by another subsidized plan and the plan was established by the business or individual.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

24. Pam (age 36) works full time earning $95,000 and participates in her employer's 401(k) program. Her spouse Jim (age 32), earns $25,000 but his company offers no qualified plan for him to participate in. How much can each deduct for a contribution into a traditional IRA? **(Page 129)**

    a. In 2011, only Jim may contribute and deduct up to $5,000. [This answer is correct. Jim can contribute $5,000 to a deductible IRA, but Pam cannot. Her phase-out is based on the joint AGI limit, as she is a plan participant.]

    b. In 2011, neither may make a deductible contribution; however, they could contribute to a nondeductible IRA or Roth IRA. [This answer is incorrect. Jim can contribute $5,000 to a deductible IRA. As his phase-out is based on the joint AGI limit, as he is a not a plan participant.]

25. All taxpayers are entitled to contribute to which of the following? **(Pages 129, 130)**

    a. A nondeductible traditional IRA. [This answer is correct. Even though taxpayers may be eligible to contribute to another IRA option, under the Internal Revenue Code, only the nondeductible IRA is available for all taxpayers regardless of income or participation in a plan.]

    b. A nondeductible traditional IRA or a Roth IRA. [This answer is incorrect. Roth IRA contributions are limited to taxpayers with qualifying incomes.]

    c. A deductible or nondeductible traditional IRA. [This answer is incorrect. Deductible traditional IRA contributions are limited to taxpayers with qualifying incomes or are not a plan participant.]

26. Which of the following statements is true regarding Roth IRA contributions? **(Page 131)**

    a. Roth IRA contributions reduce adjusted gross income. [This answer is incorrect. Under the tax code, Roth IRA contributions are not a deduction.]

    b. Roth IRA distributions are not required to begin at age 70½. [This answer is correct. There is no requirement that Roth IRA distributions begin at age 70½. Roth IRA contributions can also continue to be made after age 70½.]

27. Deductible moving expenses include which of the following? **(Page 137)**

    a. Transportation from the former residence to the new residence, temporary housing, and expenses incurred to sell a principal residence. [This answer is incorrect. Temporary housing and the expenses of selling a home are nondeductible moving expenses.]

    b. Transportation and the cost of transporting household goods from the former residence to the new residence due to a job transfer. [This answer is correct. The cost of transporting household goods and personal effects from the former residence to the new residence and the cost of traveling from the former residence to the new residence is deductible if the move is job related.]

c. All expenses incurred due to the relocation of the taxpayer. [This answer is incorrect. Certain expenses are not deductible such as meals while moving from an old residence to a new residence.]

d. Moving expenses are not deductible but may be excludible. [This answer is incorrect. Certain moving expenses are deductible according to tax laws if the move is job-related.]

28. Roger is self-employed and single. To qualify for the deduction for health insurance (for AGI), he or his policy must: **(Page 139)**

a. Not be eligible for coverage by another subsidized plan. [This answer is correct. The deduction can only be claimed for calendar months when the Roger is not eligible to participate in a subsidized health plan maintained by his employer.]

b. Meet the definition of a high-deductible insurance plan and have earnings under $150,000. [This answer is incorrect. There is no income limitation for the deduction and the deduction is not limited to high-deductible insurance plans.]

29. Mary and Barry divorced in 2011. Barry is required to pay Mary $1,000 per month for the rest of her life, with payments ceasing upon her death. Barry paid Mary 10 months in 2011. What amount can Barry deduct as alimony in 2011? **(Page 140)**

a. Unable to determine as payments may be child support if they have a child and the child lives with Mary. [This answer is incorrect. Payments are not given the appearance of child support when they continue until death.]

b. $12,000. [This answer is incorrect. Barry doesn't get a deduction for payments he didn't make in 2011.]

c. $10,000. [This answer is correct. Under IRC Sec. 71, Barry's deduction is limited to the alimony actually paid in 2011.]

d. Unable to determine as payments may be subject to re-characterization as property settlement payments. [This answer is incorrect. Alimony recapture may occur in Year 3 but the deduction for 2011 is the amount of alimony paid.]

30. When are contributions to a Health Savings Account deductible? **(Page 144)**

a. When the policy meets the definition of a high-deductible plan and the taxpayer is not eligible for coverage by another subsidized plan. [This answer is correct. The deduction is limited to high-deductible health insurance plans without nonpermitted coverage according to tax law.]

b. When the policy meets the definition of a high-deductible insurance plan and the participant has earnings under $150,000. [This answer is incorrect. There is no income limitation for the deduction.]

c. The taxpayer must not be eligible for coverage by another subsidized plan established by the business or individual. [This answer is incorrect. The taxpayer must be covered under a high deductible health plan (HDHP).]

EXAMINATION FOR CPE CREDIT

Chapter 7

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

23. John earns $39,450 and his wife earns $3,050. They are both 30 years old with no dependents and they file a joint return. What is the maximum amount they are allowed to contribute to an IRA in 2011?

    a. $5,000.

    b. $8,050.

    c. $10,000.

    d. Do not select this answer choice.

24. When must contributions to IRA accounts for the year 2011 be made?

    a. Anytime during the calendar year 2011.

    b. Anytime during the calendar year 2011 or up to the due date of the return without extensions (April 15, 2012).

    c. Anytime during the calendar year 2010 or up to the due date of the return including the extended due date (October 15, 2012).

    d. Do not select this answer choice.

25. To contribute the maximum amount to a Roth IRA in 2011, a taxpayer must:

    a. Have modified AGI of under 105,000 if single.

    b. Have modified AGI of under $169,000 if married.

    c. Have modified AGI of under $107,000 if married filing separately

    d. Have modified AGI of under $10,000 if single.

26. Which of the following tests must an individual meet for moving expenses to be deductible?

    a. The time test and the distance test.

    b. The distance test and the job change test.

    c. The job change test and the time test.

    d. The time test, the job change test and the distance test.

27. Where can self-employed individuals deduct health insurance for themselves, their spouse and their dependents?

    a. As an employee benefit expense on Schedule C.

    b. As a deduction for AGI if qualified.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

28. Taxpayers are required to use distributions from health savings accounts for medical expenses.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

29. Which of the following individuals is qualified to contribute to a health savings account?

    a. Bill, who is enrolled in a government sponsored health insurance program.

    b. Tammy, who is single and has a high-deductible health insurance policy with a $1,200 deductible in 2011.

    c. Mark, who is married and is covered by his employer's health insurance plan.

    d. Tom, who has a high-deductible health insurance policy with no maximum out-of-pocket provision in 2011.

Chapter 8: Standard Deduction

Learning Objective

Completion of this chapter will enable you to:

- Determine the standard deduction applicable to each filing status.

Introduction

Taxpayers who do not itemize their deductions generally are entitled to a standard deduction to reduce adjusted gross income in arriving at taxable income. The standard deductions are subject to inflation adjustments determined from the consumer price index.

Standard Deduction

For 2011, the applicable standard deductions available to individuals are as follows:

Filing Status	Standard Deduction
Joint filers and surviving spouses	$11,600
Head of household	$ 8,500
Single	$ 5,800
Married filing separately	$ 5,800

Married taxpayers who file separate returns must treat their deductions consistently. Thus, if one spouse elects to itemize deductions, the other spouse must also itemize even if the deductions are less than the standard deduction for married filing separately status. However, a married taxpayer who files as head of household can claim the full standard deduction even if the other spouse elects to itemize deductions. This is because the spouse filing as head of household is treated as unmarried for the taxable year even though the other spouse is treated as married. Alternatively, if the spouse filing as head of household elects to itemize, the other spouse may not claim the standard deduction.

Unlike itemized deductions and personal exemptions, the standard deduction is not subject to any phase-out rules. Also, the amount of the standard deduction for a decedent's final tax return is the same as it would have been had the decedent continued to live.

Special rules allow additional standard deductions for elderly and blind taxpayers, and mandate reduced standard deductions for certain taxpayers who are claimed as dependents on another's return.

The standard deduction is not allowed when determining the alternative minimum tax (AMT) and thus must be added back to taxable income when computing alternative minimum taxable income. Furthermore, a taxpayer who uses the standard deduction for regular tax purposes cannot itemize deductions for AMT purposes. In other words, a taxpayer who uses the standard deduction for regular taxes cannot claim itemized deductions allowable for AMT such as charitable contributions and qualified housing and investment interest expense.

Taxpayers who normally have itemized deductions just under the standard deduction amount may benefit from shifting expenses from one year to another. By "bunching" deductions, the taxpayer may realize significant tax savings by itemizing every other year, and claiming the standard deduction in the intervening years.

Practitioners should consider, in some cases, electing itemized deductions even though the total itemized deductions are less than the standard deduction. For example, when the standard deduction is added back for AMT purposes, taxpayers may have a higher tax liability than if they itemized their deductions.

Taxpayers may also elect to itemize deductions on their federal return rather than take the standard deduction if, for example, the tax benefit of being able to itemize deductions on their state tax return is greater than the tax benefit lost on the federal return by not taking the standard deduction. A taxpayer makes this election by checking the box on line 30 of Schedule A.

Additional Standard Deduction for Elderly and Blind Taxpayers

Additional standard deductions are allowed for taxpayers age 65 or older or blind as of the tax year-end. For this purpose, blind means having vision that does not exceed 20/200 in the better eye (with corrective lenses) or a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

For 2011, the additional standard deduction amounts are as follows:

Taxpayer	Amount
Age 65 or over filing jointly, as surviving spouse, or married filing separately	$1,150
Age 65 or over filing as single or head of household	$1,450
Blind filing jointly, as surviving spouse, or married filing separately	$1,150
Blind filing as single or head of household	$1,450

The additional standard deductions apply to each qualifying spouse for married couples filing jointly. An individual can receive the additional standard deduction amount for being elderly plus the additional amount for being blind. These additional standard deductions are adjusted annually for inflation.

Individuals claiming an additional deduction for blindness must obtain a certified statement from an eye physician or registered optometrist as to the nature of the blindness. If it is determined no reasonable possibility exists that an individual's vision will ever improve beyond the minimum standards for claiming blindness, the certification must include this fact. The individual should keep the certification in his records and does not have to attach it to the tax return. Any individual claiming the additional deduction also must check the appropriate boxes in the Tax and Credits section of page 2 of Form 1040 to indicate elderly or blind status.

Reduced Standard Deduction for Dependents

Taxpayers who are or can be claimed as dependents on another return, the standard deduction for 2011 is limited to the greater of (1) $950, or (2) earned income plus $300 (not to exceed the standard deduction that would be allowable in any case). The deduction amount is adjusted annually for inflation.

The reduced standard deduction for taxpayers claimed as dependents on other returns applies only to the basic standard deduction. Dependent taxpayers who are elderly or blind can claim the additional standard deductions, regardless of the level of earned income. Thus, for example, in 2011 an elderly, single dependent taxpayer with no earned income can claim the $950 reduced basic standard deduction plus the $1,450 additional standard deduction for elderly single taxpayers.

Chapter 8 Exercises

Question 1: Married with children.

Part 1: Tom and Vanessa are married and do not own a home. The total of their itemized deductions for 2011 is $10,900 which consists of mostly state taxes and charitable deductions. Is it better for them to utilize their itemized deductions or their available standard deduction?

Part 2: What determines which one they will use?

Part 3: What if they had two children, would that change your answer?

Chapter 8 Exercise Solutions

Question 1: Married with children.

Part 1: Tom and Vanessa are married and do not own a home. The total of their itemized deductions for 2011 is $10,900 which consists of mostly state taxes and charitable deductions. Is it better for them to utilize their itemized deductions or their available standard deduction?

Answer: *They should utilize their standard deduction of $11,600.*

Part 2: What determines which one they will use?

Answer: *They are able to use whichever one is higher.*

Part 3: What if they had two children, would that change your answer?

Answer: *No.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following is correct regarding taxpayers who file married filing separately?

    a. Both must use the standard deduction or itemize.

    b. Each spouse may choose either to take the standard deduction or itemize.

32. Irv and Lucille file jointly and do not itemize deductions. Irv is age 65 and blind with no hope of recovering his sight. Lucille is also age 65. What is Irv and Lucille’s 2011 standard deduction?

    a. $11,600.

    b. $13,900.

    c. $15,050.

    d. $15,350.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

31. Which of the following is correct regarding taxpayers who file married filing separately? **(Page 159)**

    a. Both must use the standard deduction or itemize. [This answer is correct. Under current law, married taxpayers who file separate returns must treat their deductions consistently. Thus, if one spouse elects to itemize deductions, the other spouse must also itemize even if the deductions are less than the standard deduction for married filing separately status.]

    b. Each spouse may choose either to take the standard deduction or itemize. [This answer is incorrect. Unless one spouse qualifies as Head of Household, MFS requires consistency; thus, both spouses must either take the standard deduction or itemize.]

32. Irv and Lucille file jointly and do not itemize deductions. Irv is age 65 and blind with no hope of recovering his sight. Lucille is also age 65. What is Irv and Lucille's 2011 standard deduction? **(Page 160)**

    a. $11,600. [This answer is incorrect. The taxpayers qualify for additional standard deduction amounts.]

    b. $13,900. [This answer is incorrect. Irv qualifies for the additional standard deduction amounts for both age and sight.]

    c. $15,050. [This answer is correct. The taxpayers qualify for the three additional standard deduction amounts. They each qualify for an extra $1,150 for age and Irv qualifies for an additional $1,150 for sight.]

    d. $15,350. [This answer is incorrect. Irv receives only $1,150 for his extra standard deduction for blindness because he is married.]

EXAMINATION FOR CPE CREDIT

Chapter 8

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

30. Which of the following is correct regarding the standard deduction?

    a. The standard deduction phases out at higher income levels.

    b. The standard deduction must be added back to taxable income when computing alternative minimum taxable income.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

31. Fred is a 16-year-old dependent child whose summer job paid him $2,500 in 2011. He also had $400 of interest income. What is Fred's standard deduction for the year?

    a. $300.

    b. $2,500.

    c. $2,800.

    d. $5,700.

Chapter 9: Medical Expenses

Learning Objective

Completion of this chapter will enable you to:

- Identify deductible medical expenses and apply the limits on the deductibility of long-term care insurance.

Introduction

The itemized deduction phase-out rules specifically exclude medical expenses. Therefore, expenses for medical and dental care and health insurance premiums that exceed 7.5% of adjusted gross income (AGI) are fully deductible on Schedule A of Form 1040 for all taxpayers who itemize deductions. For alternative minimum tax (AMT), medical expenses must exceed 10% of AGI to yield any benefit.

Generally, medical care is defined as an amount paid for (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for a purpose affecting the body's structure or function; (2) transportation primarily for and essential to medical care; (3) qualified long-term care services; and (4) insurance for medical care or any qualified long-term care insurance contract. An expenditure that is merely beneficial to the general health of an individual is not an expenditure for medical care.

A refund (from insurance, etc.) occurring in the same year medical expenses are paid offsets the current-year medical expense deduction. However, a refund received during the year for medical expenses paid in prior years does not reduce the current-year medical expense deduction. Instead, such refunds are included in income to the extent a tax benefit was obtained from the prior-year deduction.

Identifying Deductible Medical Expenses

Only the medical expenses in excess of 7.5% of AGI are deductible. Medical expense is a broad term that includes medical, dental, vision, and mental/emotional expenses. Over-the-counter medicines do not qualify as medical expenses, even though they may be allowed under a flexible spending account plan.

Note: Under current tax law, in 2011 over-the-counter medicines will not be allowed under a flexible spending account plan unless prescribed by a doctor.

Deducting medical expenses is becoming easier as the list of qualifying medical expenses has expanded, the cost of medical care has increased, and medical insurance costs have risen drastically. However, deducting medical expenses is more difficult for taxpayers who are subject to the AMT.

Deductible medical expenses include amounts paid for:

1. The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any part or function of the body;
2. Transportation primarily for and essential to medical care;

3. Qualified long-term care services; or
4. Insurance premiums covering medical care described above.

See the "Qualified Medical Expense Checklist" that follows.

Qualified Medical Expense Checklist
(not all-inclusive)

- ☐ Abortion
- ☐ Acupuncture
- ☐ Alcoholism – inpatient treatment at a therapeutic center for alcohol addiction (includes meals and lodging provided by the center)
- ☐ Ambulance
- ☐ Artificial Limbs and Artificial Teeth
- ☐ Birth Control Pills
- ☐ Braille books and magazines to the extent the cost exceeds a regular printed edition
- ☐ Breast reconstruction after a mastectomy (Rev. Rul. 2003-57)
- ☐ Car – special hand controls, etc. for disabled individuals
- ☐ Chiropractor
- ☐ Christian Science Practitioner
- ☐ Contact Lens – including equipment and materials such as a saline and enzyme cleaner
- ☐ Crutches (Rev. Rul. 2003-58)
- ☐ Dentists & Dental Treatment
- ☐ Drug Addiction – inpatient treatment at a therapeutic center (includes meals and lodging)
- ☐ Drugs – prescription
- ☐ Elastic hosiery
- ☐ Equipment, supplies and diagnostic devices even if not prescribed (Rev. Rul. 2003-58)
- ☐ Eyeglasses – includes examination fees
- ☐ Fertility Enhancement – in vitro and surgery (PLR 200318017)
- ☐ Guide Dog or Other Animal – includes care expenses of the animal
- ☐ Health Club – if the treatment is prescribed and the physician issued a statement that the treatment is necessary to alleviate a physical or mental defect or illness of the individual receiving the treatment
- ☐ Health Maintenance Organization (HMO) – treated as insurance premiums
- ☐ Hearing Aids (including batteries)
- ☐ Home Care
- ☐ Hospital Services
- ☐ Insurance Premiums – hospitalization, surgical fees, X-rays, etc. including prescription drugs, replacement of lost or damaged contact lenses membership in "free choice" medical services, Medicare or qualified long-term care
- ☐ Laboratory Fees
- ☐ Laser Eye Surgery
- ☐ Lead-Based Paint Removal – to prevent a child who has or who has had lead poisoning from eating the paint
- ☐ Learning Disability – tuition fees for a special school for a child with severe learning disabilities caused by mental or physical impairments, including nervous systems disorders. Doctors must recommend child attend.
- ☐ Legal Fees – necessary to authorize treatment for mental illness
- ☐ Lodging while away from home – $50 per night for each person. Includes a person accompanying an ill person—both parties will be allowed to deduct up to $50 per night. Lodging not provided in a hospital or similar institution must meet all of the following:
    - Lodging is primarily and essentially for medical care and not lavish or extravagant;
    - Medical care is provided by a doctor in a licensed hospital or equivalent; and
    - No significant element of personal pleasure, recreation or vacation in the travel

Qualified Medical Expense Checklist
(not all-inclusive)

- ☐ Meals – only for inpatient care
- ☐ Medical Conferences – admission to or transportation to a medical conference if it concerns the chronic illness of you, spouse, or dependent. Must spend a majority of your time at the conference attending sessions. Does not include meals or lodging
- ☐ Medicines – prescribed medicines and drugs (requires a prescription) and insulin
- ☐ Medical Services – for legal medical services provided by physicians, surgeons, specialists, or other medical practitioners
- ☐ Mentally Retarded – the cost of keeping a mentally retarded person in a special home, not the home of a relative, on the recommendation of a psychiatrist to help the person adjust
- ☐ Nursing Home – cost of medical care in a nursing home, including the cost of meals and lodging in the home if the main reason for being there is to get medical care. If the reason for being there is personal, deduct only the portion for nursing and medical care
- ☐ Nursing Services – services need not be performed by a nurse as long as the services are of a kind generally performed by a nurse (giving medication, changing dressings, bathing, etc.)
- ☐ Operations – legal operations that are necessary (not cosmetic surgery)
- ☐ Optometrist
- ☐ Oxygen – for oxygen and oxygen equipment to relieve breathing problems caused by a medical condition
- ☐ Psychiatric Care – includes the cost of supporting a mentally ill dependent at a specially equipped medical center; does not include psychoanalysis you must get as a part of your training to be a psychoanalyst
- ☐ Schools and Education, Special – payments to a special impaired or physically disabled person if the main reason for using the school is its resources for relieving the disability. Includes the cost of teaching Braille to the visually impaired, teaching lip reading to the hearing impaired and giving remedial language training to correct a condition caused by a birth defect. You cannot include the cost of sending a problem child to a special school for benefits the child may get from the course study and the disciplinary methods
- ☐ Sterilization – cost of a legal sterilization
- ☐ Stop-Smoking Program – stop-smoking program. You cannot include drugs that do not require a prescription such as a nicotine patch or gum (Rev. Rul. 99-28)
- ☐ Telephone – the cost and repair of special telephone equipment that lets a hearing-impaired person communicate over a regular telephone
- ☐ Television – the cost of equipment that displays the audio part of a television program for the hearing-impaired
- ☐ Therapy
- ☐ Transplants – surgical, laboratory, and transportation expenses for a donor or possible donor of an organ
- ☐ Transportation Costs – primarily for and essential to medical care, includes bus, taxi, train, plane, ambulance, parking fees, tolls, and automobile expenses at the greater of out-of-pocket expenses for gas and oil or $.20 per mile for January through June of 2008; the mileage rate for medical was increased July 1, 2008 to $.27 per mile.
- ☐ Trips – transportation to another city if the trip is primarily for and essential to receiving medical services. Does not include vacations even if recommended by a doctor
- ☐ Weight-Loss Programs – undertaken at a physician’s direction to treat an existing disease (such as heart disease or obesity). Not deductible if it is to improve your general health and well-being (Rev. Rul. 2002-19 and Rev. Rul. 79-151)
- ☐ Wheelchair – used mainly for the relief of sickness or disability and not just to provide transportation to and from work
- ☐ X-Rays

Nondeductible Medical Expenses
(not all-inclusive)

- ☐ Controlled substances in violation of state law (e.g., marijuana)
- ☐ Cosmetic surgery
- ☐ Dance lessons
- ☐ Diaper service
- ☐ Dietary foods if not prescribed by a physician for an existing condition
- ☐ Exercise program to improve general health
- ☐ Funeral expenses

Limitations apply, such as:

- Qualifying expenses must be reduced by insurance reimbursements.
- Only qualifying medical expenses that exceed 7.5% of AGI are deductible.

Deductible medical expenses must be paid on behalf of an eligible individual. An eligible individual is:

> The taxpayer, spouse or dependent (as defined in IRC Sec. 152, determined without regard to the earnings test) either when the services were provided or when they were paid. The definition of a qualifying child and a qualifying relative apply, without the earnings test. The uniform definition of a child must pass:
>
> 1) Relationship test;
> 2) Place of abode for more than half the year;
> 3) Age test; **and**
> 4) Not providing over half of own support.

An eligible individual includes a spouse or former spouse, if the marriage existed either when the expenses were incurred or when the bills were paid.

Example: In 2011, Cary qualified as a dependent for his mother, but did not qualify as a dependent in 2012. In 2012, Cary's mother paid $800 for medical expenses that were provided to Cary in 2011. Are these qualified medical expenses for Cary's mother? If so, in which year can she deduct these as medical expenses?

Yes. These are qualified medical expenses, because Cary was a dependent during the year they were incurred, 2011. Cary's mother can deduct these in 2012, the year they were paid.

Children of Divorced Parents

Both parents may deduct the medical expenses they paid, regardless of which parent claims the child as a dependent. However, at least one of the parents must claim, or be entitled to claim, the child as a dependent.

Capital Expenditures Deductible as Medical Expenses

As long as the special equipment or improvement to the home is for medical care, it is deductible.

- Amount deductible: The cost of the improvement minus the increase in the FMV of the property.
- Common home improvements that may be deductible include: widening hallways and doorways, railings and support bars in bathrooms, modifying kitchen cabinets, elevators or lifts on stairways, wheelchair ramps, etc.

Capital expenditures must be incurred with the “primary purpose of” and “directly related to” the medical care of the patient.

Long-term Care

Long-term care premiums are deductible as a medical cost, based upon the following limits:

Long-term Care Premiums		
Age	Deduction Limit	
	2010	2011
Less than 40	$ 330	$ 340
40–50	$ 620	$ 640
50–60	$1,230	$1,270
60–70	$3,290	$3,390
Over 70	$4,110	$4,240

Chapter 9 Exercises

Question 1: Medical expenses.

In general, the average household with two income earners (received via W-2) will not be able to deduct medical expenses. Why?

Question 2: Medical expenses of dependent.

Dawn, age 20, is a full-time student and receives more than half of her support from her parents, who also paid $1,200 of her medical bills in 2011. Can her parents claim a deduction for the medical expenses they paid on her behalf? Why or why not?

Question 3: Medical expenses of dependent.

Wayne, age 22, receives more than 50% of his support from his parents. Wayne earned $3,850 in 2011 and was not a full-time student. He cannot be claimed as a dependent on his parents' return for purposes of the personal exemption because he is neither (1) a "qualifying child" because he does not meet the age requirement since he is over 18 and is not a full-time student [IRC Sec. 152(c)(3)], or (2) a "qualifying relative" because his gross income is higher than the $3,700 exemption amount for 2011 [IRC Sec. 152(d)(1)(B)]. Can his parents claim a deduction for the medical expenses they paid on his behalf? Why or why not?

Question 4: Medical expenses of parent.

Dorothy, age 70, receives more than 50% of her support from her daughter, Sonja, who also paid $2,000 of Dorothy's medical expenses in 2011. Dorothy earned $3,800 in 2011 from a part-time job; therefore, she cannot be claimed as a dependent on Sonja's return. Can Sonja claim a deduction for the medical expenses paid on Dorothy's behalf? Why or why not?

Chapter 9 Exercise Solutions

Question 1: Medical expenses.

In general, the average household with two income earners (received via W-2) will not be able to deduct medical expenses. Why?

Answer: *Because generally health insurance will cover most medical expenses and the taxpayers will not exceed the 7.5% threshold. Health insurance is generally either covered by the taxpayer's employer or taken as a payroll deduction. The payroll deduction is taken out of the taxpayer's wages pre-tax which allows the taxpayer to deduct health insurance without regard to the 7.5% threshold.*

Question 2: Medical expenses of dependent.

Dawn, age 20, is a full-time student and receives more than half of her support from her parents, who also paid $1,200 of her medical bills in 2011. Can her parents claim a deduction for the medical expenses they paid on her behalf? Why or why not?

Answer: *Dawn's parents can deduct (subject to the 7.5%-of-AGI limitation) the medical expenses. She meets the definition of a dependent.*

Question 3: Medical expenses of dependent.

Wayne, age 22, receives more than 50% of his support from his parents. Wayne earned $3,850 in 2011 and was not a full-time student. He cannot be claimed as a dependent on his parents' return for purposes of the personal exemption because he is neither (1) a "qualifying child" because he does not meet the age requirement since he is over 18 and is not a full-time student [IRC Sec. 152(c)(3)], or (2) a "qualifying relative" because his gross income is higher than the $3,700 exemption amount for 2011 [IRC Sec. 152(d)(1)(B)]. Can his parents claim a deduction for the medical expenses they paid on his behalf? Why or why not?

Answer: *Wayne's parents can deduct (subject to the 7.5%-of-AGI limitation) the medical expenses they paid for Wayne in 2011 because he meets the definition of a dependent for purposes of the medical expense deduction. Under IRC Sec. 213(a), the gross income test is ignored for the "qualifying relative" definition. Therefore Wayne is a "dependent" for the medical expense deduction, but not for the personal exemption.*

Question 4: Medical expenses of parent.

Dorothy, age 70, receives more than 50% of her support from her daughter, Sonja, who also paid $2,000 of Dorothy's medical expenses in 2011. Dorothy earned $3,800 in 2011 from a part-time job; therefore, she cannot be claimed as a dependent on Sonja's return. Can Sonja claim a deduction for the medical expenses paid on Dorothy's behalf? Why or why not?

Answer: *Sonja still can deduct (subject to the 7.5%-of-AGI limitation) the $2,000 of medical expenses because Dorothy meets the definition of a dependent for the medical expense deduction, even though Sonja cannot claim a personal exemption for her because of her gross income. The gross income level of an otherwise dependent parent is ignored for purposes of the medical expense deduction.*

Note that medical expenses are deductible only by the taxpayer who actually pays them. Thus, taxpayers claiming medical expenses paid for a dependent must pay the expense directly to the medical provider rather than the dependent. Furthermore, large medical bills for parents or persons other than dependent minor children should be paid directly to the medical service providers (e.g., doctors, hospitals, etc.) to avoid taxable gifts that are subject to gift tax or reduce the payer's applicable credit amount (Ltr. Rul. 9023030). Amounts paid directly to medical service providers are not taxable transfers (i.e., gifts) [IRC Sec. 2503(e)].

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. Taxpayers incurred the following expenses for their health care. Which list qualifies as deductible medical expenses?

    a. Care for broken leg, annual physical, anti-smoking clinic and Weight Watchers meetings to maintain current healthy weight.

    b. Care for broken leg, annual physical, physical therapy and medical prescriptions.

    c. Care for broken leg, annual physical, physical therapy, medical prescriptions and over-the-counter medicines.

    d. Care for broken leg, annual physical, physical therapy, and exercise program to improve general health.

34. Bruce and Allison file jointly and have long-term care insurance. Bruce (age 58) pays premiums of $1,400 and Allison (age 61) pays premiums of $3,100. What amount qualifies as a medical expense if they itemize their deductions in 2011?

    a. $4,330.

    b. $4,370.

    c. $4,500.

    d. $4,660.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

33. Taxpayers incurred the following expenses for their health care. Which list qualifies as deductible medical expenses? **(Pages 169, 170)**

    a. Care for broken leg, annual physical, anti-smoking clinic and Weight Watchers meetings to maintain current healthy weight. [This answer is incorrect. Weight Watcher's fees do not qualify as a deductible medical expense without a doctor's recommendation to treat a medical disease.]

    b. Care for broken leg, annual physical, physical therapy and medical prescriptions. [This answer is correct. All items qualify for the deduction according to the Internal Revenue Code.]

    c. Care for broken leg, annual physical, physical therapy, medical prescriptions and over-the-counter medicines. [This answer is incorrect. Over-the-counter medication does not qualify as a deduction even though they qualify as medical expenses in a flexible spending account.]

    d. Care for broken leg, annual physical, physical therapy, and exercise program to improve general health. [This answer is incorrect. An exercise program to improve general health is a nondeductible medical expense.]

34. Bruce and Allison file jointly and have long-term care insurance. Bruce (age 58) pays premiums of $1,400 and Allison (age 61) pays premiums of $3,100. What amount qualifies as a medical expense if they itemize their deductions in 2011? **(Page 173)**

    a. $4,330. [This answer is incorrect. This is the amount that would have qualified as a medical expense in 2010.]

    b. **$4,370. [This answer is correct. Bruce may deduct $1,270 of his premium. Allison's deduction is $3,100, which is less than the premium limitation.]**

    c. $4,500. [This answer is incorrect. This is the amount the taxpayers paid for premiums but the entire amount is not deductible as a medical expense in 2011.]

    d. $4,660. [This answer is incorrect. The taxpayers are limited to the amounts paid or the age limited amounts.]

EXAMINATION FOR CPE CREDIT

Chapter 9

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

32. Medical expenses are deductible to the extent they exceed what percentage (%) of Adjusted Gross Income (AGI)?

    a. 2%.

    b. 7.5%.

    c. 10%.

    d. Medical expenses are deductible regardless of AGI.

33. Which of the following is a deductible medical expense?

    a. Surgery expenses paid by a parent for a child who is claimed by the custodial parent.

    b. Surgery expenses for parent who does not qualify as a dependent based on the support test.

    c. Surgery expenses for neighbor resulting from your dog's bite.

    d. Do not select this answer choice.

Chapter 10: Charitable Contributions

Learning Objective

Completion of this chapter will enable you to:

- Identify and substantiate charitable contributions, applying the limitations on the deduction of charitable contributions.

Introduction

Individual taxpayers who contribute cash or property to a *qualified organization* can claim the contribution as an itemized deduction. Not all nonprofit organizations are qualified organizations for charitable contribution deduction purposes. The IRS publishes, and updates quarterly, a master list of qualified organizations; however, the list is not all-inclusive. IRS Pub. 78 can also be accessed via the Internet at **www.irs.gov**. Also, the IRS periodically issues announcements indicating organizations that have recently failed to establish or maintain their status as public charities.

An individual's deduction in a tax year is subject to various limitations. Excess contributions can be carried forward for five years and deducted on a first-in, first-out (FIFO) basis.

A valid charitable contribution may be disallowed by the IRS if not adequately substantiated.

Enhanced Recordkeeping Requirements for Charitable Contributions

The Pension Protection Act of 2006 (PPA 2006) includes several provisions that require enhanced recordkeeping for charitable contributions:

1. For cash contributions, taxpayers must have a statement from the charity showing the name of the charity, the date of the contribution, and the amount given; alternatively, a taxpayer can have a bank record of the contribution. There is **no** dollar threshold for this recordkeeping requirement.
2. For noncash contributions:
    a. Deductions may not be taken for donations of used clothing and household items that are not in "good used condition or better." Note that the new rule applies only to used clothing and household items. Art, collectibles, and other nonhousehold items are not subject to this rule.
    b. The law does not define what "good" is. Discussing the condition of donated items always makes for interesting conversations during tax season.

In 2006 and 2007, taxpayers age 70½ and older could transfer up to $100,000 from a traditional or Roth IRA to qualified charities allowed under PPA 2006. The 2008 Extenders Act extended this provision for 2008 and 2009. *The Tax Relief Act of 2010 further extends this provision for 2010 and 2011.*

Enhanced reporting requirements apply to donations of cars, boats and airplanes.

1. If the value of the vehicle is $500 or less, the normal donation rules apply.

2. If the value is over $500, there are three methods to determine deduction:
    a. If vehicle is sold by the charity without any significant intervening use or material improvement—deduction is limited to the gross proceeds realized by the charity.
    b. If the charity intends to make significant use or materially improve the vehicle—deduction is generally its FMV.
    c. If the charity sells the vehicle at substantially below FMV to needy or disadvantaged individuals or families as part of the charity's purpose—deduction is generally the FMV.

Contemporaneous written acknowledgement from the charity is required and must:

1. Be attached to the 1040 tax return.
2. Include the following information:
    a. Taxpayer's name and ID number;
    b. Vehicle identification number (VIN); and
    c. Statement certifying that:
        1) The vehicle was sold, the gross proceeds received from the sale, and a statement that the deduction may not be more than the gross proceeds; or
        2) The intended use, duration of that use, and that the charity will not sell the vehicle before completion of that use; or
        3) The intended material improvement, and that the charity will not sell the vehicle before the completion of the improvement; or
        4) The vehicle was sold substantially below FMV to a needy or disadvantaged individual as part of the charity's purpose.

Contemporaneous means no later than 30 days after the date of sale or, if the charity intends to make significant intervening use or materially improve the vehicle, 30 days from the date of the contribution.

Donors should receive Form 1098-C from the charity, reporting information about the vehicle donation that can be included with the tax return. A revised Form 1098-C has been released by the IRS, allowing the form to be used as a contemporaneous written acknowledgment for a qualified vehicle with a claimed value of at least $250 but not more than $500.

Charitable Contributions Are Made to Qualified Organizations

A charitable contribution is one made only to a qualified organization, one that is not set aside for use by a specific person, and only to the extent it exceeds the value of benefit received by the donor.

Qualifying Organizations. To be eligible to receive deductible gifts, an organization must be described in IRC Sec. 170(c):

1. Government: The United States, a state, a possession of the United States, or any political subdivision thereof, or the District of Columbia, but only if the contribution is made for exclusively public purposes.

2. A corporation, trust, or community chest, fund or foundation described in IRC Sec. 170(c)(2).
3. War veterans' groups, auxiliary unit or society of, or trust or foundation for, any such post or organization, provided no part of the net earnings inures to the benefit of any private shareholder or individual.
4. Fraternal lodges, societies, orders, but only if the contribution is used exclusively for religious, charitable, scientific, literary, educational, or the prevention of cruelty to children or animals. Dues, fees or bills paid do not qualify.
5. Nonprofit cemetery companies, operated exclusively for the benefit of its members and no part of net earnings inures to the benefits of any private shareholder or individual.

Foreign Country Contributions. Contributions to certain charitable organizations in Canada, Mexico and other foreign countries may be covered under international treaties between the U.S. and those countries. Some treaties require the taxpayer to have income from sources within the foreign country.

Out-of-pocket Expenses for Volunteer Work. Taxpayers may be able to deduct some amounts paid in providing services to a qualified organization.

1. To be deductible, the amounts must be:
   a. Unreimbursed;
   b. Directly connected with the services;
   c. Expenses incurred only because of the services given; and
   d. Not personal, living, or family expenses.
2. Car expenses are deductible at the greater of $ .14 per mile, or actual cost of gas and oil that are directly related to the use in giving the service. Add parking fees and tolls to either method.
3. Travel expenses necessarily incurred while away from home performing services for a qualified organization are deductible only if:
   a. Taxpayer is "on duty in a genuine and substantial sense throughout the trip"; and
   b. "No significant element of personal pleasure, recreation or vacation" is received by the taxpayer.
4. Applies whether paid directly (by the taxpayer) or indirectly (paid by the taxpayer to the charitable organization, which then pays the travel expenses). Deductible travel expenses include:
   a. Air, rail and bus transportation;
   b. Out-of-pocket expenses for your car;
   c. Taxi and other costs of local transportation;
   d. Lodging costs; and
   e. Meals.

Nondeductible Contributions. You cannot deduct a contribution:

1. To a specific individual;
2. To a nonqualified organization;

3. From which you receive a benefit;
4. Of your time or services;
5. Appraisal fees (these are deducted as 2% Miscellaneous); or
6. Partial interest in property (restrictions apply).

When to Deduct. Deduct a contribution only in the year actually made in cash or other property. The following dates apply:

1. Checks—the date mailed.
2. Credit card—the date the charge is made.
3. Pay-by-phone account—the date the financial institution pays the account.
4. Promissory note: if you issue a promissory note to the organization—the date the note is paid.
5. Borrowed funds: if you borrow money and then donate the funds to an organization—the date the contribution is made, regardless of when the loan is repaid.

Substantiation Requirements

Payroll deductions can be substantiated with a pay stub, W-2 or other reliable written record.

For cash donations less than $250, a bank record (i.e., cancelled check) or written communication from the charity is required.

For noncash donations, a receipt or other written record showing the name of the organization, the date and location of the contribution, and a reasonably detailed description of the property.

For contributions of $250 or more (cash and noncash) at one time:

1. The taxpayer must receive a contemporaneous written acknowledgement from the donee organization with the donee's name, address and containing the following:
   a. Amount and description of cash and/or property contributed, date and location of contribution.
   b. Statement as to whether goods or services were received from the organization and, if so, the fair market value of same.
   c. Must be obtained the earlier of the date return is filed or due date of return including extensions.
2. For out-of-pocket expenses, the taxpayer must:
   a. Maintain adequate records to prove amount, and
   b. Obtain acknowledgement from the qualified organization with the above information plus a description of the services provided. The organization, however, is **not** required to include the amount of the out-of-pocket expenses in the acknowledgement.

A cancelled check by itself is not sufficient.

For noncash charitable contributions greater than $500:

1. Attach Form 8283, Section A; and
2. Taxpayers must have records showing when and how asset was acquired and the property's cost or basis.

For noncash charitable contributions exceeding $5,000 for an item or group of like items:

1. Attach Form 8283, Section B signed and dated by the donee **and** a qualified appraiser.
2. A qualified appraisal is generally required.

The appraiser must hold himself or herself out to the public as an appraiser and regularly perform appraisals.

The appraiser cannot be the donor, donee, employee of donor or donee, or a party to the transaction (with very specific exceptions) or parties related to the donor and donee.

The appraisal must be done not earlier than 60 days before the gift and not later than the return's due date (including extensions).

An appraisal is not required for publicly traded securities.

Limits on Deductions

Generally, a charitable contribution is limited to either 50%, 30% or 20% of the individual's AGI, ignoring any NOL carryback. The percent is determined by the type of charitable organization. The exception is the special 30% limit on the donation of certain capital-gain property.

Fifty-percent-limit organizations include:

- Churches, religious associations;
- Educational organizations and organizations that administer property and make expenditures for the benefit of state and municipal colleges and universities;
- Hospitals and certain medical research organizations associated with these hospitals;
- The United States or any state, U.S. possession, political subdivision, or an Indian tribal government, provided the gift was made exclusively for public purposes;
- Public charities which categories include traditional fee-for-service and support organizations;
- Private operating foundations; and
- A private nonoperating foundation that distributes 100% of the contributions it received during the year to qualifying public charities.

How can you find out if an organization is a 50% limit organization? For starters, ask the organization. Most organizations know if they are a 50% limit organization. If you have no luck there, try IRS Pub. 78, "Cumulative List of Organizations," which is available online

at **www.IRS.gov**. You can also check other website resources such as **www.JustGive.org** and **www.GuideStar.org**.

Thirty-percent-limit organizations are all qualified organizations other than 50% limit organizations, including:

- War veterans' groups;
- Nonprofit cemetery companies; and
- Domestic fraternal societies.

Special 30%-limit capital gain property:

- Relates to the donation of capital gain property, such as real estate, artwork or securities to a 50%-limit organization.
- Does not apply if donation is to a non-50%-limit organization, in which case the 20% limit applies.
- Does not apply if an election is made to reduce the FMV by the long-term capital gain (i.e., to deduct only the basis).
- Multiple capital gain donations are not cumulative against 30% of AGI. Each donation is separately limited by 30% of AGI.

Last but not least, there is a 20%-of-AGI limit for gifts of capital gain (appreciated) property to or for the use of qualified organizations other than 50%-limit organizations.

Value of Contributions

The value for used clothing, household goods and personal items is the FMV of the items as sold in thrift shops. Resources for valuation guides include:

- 1040 Quickfinder® Handbook
- **www.SalvationArmyUSA.org**

Appreciated Property. For ordinary income property—if the sale of the property on the date contributed would have resulted in ordinary income or short-term capital gains, the charitable deduction is FMV minus the ordinary gain—generally resulting in cost or basis. Examples: inventory, art works and manuscripts created by the donor, and capital assets held for less than one year.

For capital gain property—if the sale of property on the date contributed would have resulted in long-term capital gain, generally the charitable deduction equals the FMV of the property. Examples of such property include stocks, bonds, jewelry, real property, depreciable property, personal cars and furniture.

Exception. The FMV of capital gain property must be reduced to basis if:

1. Contributed to certain private nonoperating foundations;

2. Tangible personal property that is put to an unrelated use by the charitable organization; or
3. 50% limit is used instead of the 30% limit for capital gains.

For investment property **increased** in value (capital gain), donate property and deduct the full FMV (less allowable depreciation), even though property is not reported as income.

For investment property **decreased** in value (capital loss): if the property itself is donated, only the charitable donation at FMV is realized. Sell the property and donate the proceeds. This generates a capital loss from the sale and a charitable deduction for the donation.

Goods or Services Received. A charitable deduction is reduced by the FMV of goods or services received from the charity.

Certain goods and services may be disregarded:

1. Annual membership benefits up to $75 per year;
2. Goods with an insubstantial value where the benefits are the lesser of 2% of amount contributed or $95, amount contributed is $47.50 or more and benefits do not exceed $9.50, or receive free unordered benefits that do not exceed $9.50.
3. Donations to a college or university for the right to buy tickets to athletic events are permitted to be deducted at 80%.

Example: Joe donates $1,000 to his alma mater. In return, the University sends him a hat valued at $50. Joe can deduct $950.

Example: Bill paid $10,000 to the University of Texas to have the right to buy Longhorn football tickets. Bill can deduct $8,000 ($10,000 × 80%).

Ordering Rules

The following ordering rules apply:

1. Overall, donor's contribution cannot exceed 50% of AGI.
2. Contributions subject to 50% limit.
3. Contributions of cash and ordinary income property subject to 30% limitation.
4. Contributions of 30% capital gain property.
5. Contributions of 20% capital gain property.

Carryover Rules

Unused contributions are carried over five years. In carryover years, current contributions are deducted first. The carryover is considered even when using the standard deduction. A carry-over allocable to the deceased spouse cannot be used by the surviving spouse after the year of death.

Chapter 10 Exercise

Question 1: Substantiation requirements for out-of-pocket expenses.

During 2011, Jett was a member of the National Cancer Society's (NCS) board of directors. NCS's offices are located in another state. Because board members serve at their own expense, Jett incurred approximately $800 of out-of-pocket expenses (for airfare, meals, hotel, etc.) each time he traveled to a board meeting. Also during 2011, Jett and his wife served as chaperons when their church's youth choir traveled to Washington, D.C. Their unreimbursed expenses for that trip totaled $600.

Their out-of-pocket expenses are properly documented and there was no significant element of personal pleasure involved in the travel. The Nelsons do not receive written acknowledgement from either NCS or their church. Is it true that the Nelson's can claim a charitable contribution deduction for the expenses? Why or why not?

Chapter 10 Exercise Solution

Question 1: Substantiation requirements for out-of-pocket expenses.

During 2011, Jett was a member of the National Cancer Society's (NCS) board of directors. NCS's offices are located in another state. Because board members serve at their own expense, Jett incurred approximately $800 of out-of-pocket expenses (for airfare, meals, hotel, etc.) each time he traveled to a board meeting. Also during 2011, Jett and his wife served as chaperons when their church's youth choir traveled to Washington, D.C. Their unreimbursed expenses for that trip totaled $600.

Their out-of-pocket expenses are properly documented and there was no significant element of personal pleasure involved in the travel. The Nelsons do not receive written acknowledgement from either NCS or their church. Is it true that the Nelson's can claim a charitable contribution deduction for the expenses? Why or why not?

Answer: *The Nelsons may not claim a deduction for the expenses unless they receive appropriate acknowledgments from NCS and their church. The acknowledgments must be received by the same deadline that applies to cash and property donations (i.e., by the earlier of when their 2011 return is due or filed).*

Volunteers who incur out-of-pocket expenses must keep detailed records of those expenditures. If the total of such expenses is $250 or more for a single charitable activity, the volunteer must have a written receipt from the charity describing the services provided by him and whether he received any goods or services (including value) from the charity in consideration Reg. 1.170A-13(f)(10)).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. During the year, Joan gave $100 each month to State University by writing checks. What substantiation must Joan receive and retain if she is to claim a charitable contribution deduction?

    a. A contemporaneous receipt from State University because her contributions total $1,200.

    b. Her cancelled checks are sufficient.

36. Marilyn donated appreciated stock (with an original cost basis of $10,000 in 1994) to her church in 2011. The FMV of the stock at the time of the gift was $60,000. Her adjusted gross income is $90,000. What amount will she be able to deduct in 2011 as a result of this donation?

    a. $10,000.

    b. $27,000.

    c. $30,000.

    d. $50,000.

37. What are gifts of property held more than one year given to a qualified charity valued at?

    a. Cost.

    b. Fair market value unless an automobile is donated and subsequently sold or capital gain property is give to certain types of charities.

38. In which of the following situations is a charitable deduction reduced by the FMV of goods or services received from the charity?

    a. Tom donates $100 to the University of Texas and receives a $25 leather portfolio.

    b. Annual membership benefits of $50 per year.

    c. A donation to Michigan State University for the right to buy basketball tickets.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

35. During the year, Joan gave $100 each month to State University by writing checks. What substantiation must Joan receive and retain if she is to claim a charitable contribution deduction? **(Page 184)**

    a. A contemporaneous receipt from State University because her contributions total $1,200. [This answer is incorrect. Each check is a separate contribution.]

    b. Her cancelled checks are sufficient. [This answer is correct. A cancelled check is sufficient when the contribution is under $250.]

36. Marilyn donated appreciated stock (with an original cost basis of $10,000 in 1994) to her church in 2011. The FMV of the stock at the time of the gift was $60,000. Her adjusted gross income is $90,000. What amount will she be able to deduct in 2011 as a result of this donation? **(Page 186)**

    a. $10,000. [This answer is incorrect. Long-term capital gain property is valued at its FMV.]

    b. $27,000. [This answer is correct. Long-term capital gain property is valued at its FMV. However the deduction in a particular year is limited to 30% of AGI if given to a 50% limit organization.]

    c. $30,000. [This answer is incorrect. Long-term capital gain property such as securities have a special 30% of AGI limit.]

    d. $50,000. [This answer is incorrect. The deduction is limited by the type of organization to which the donation is made and the type of property that is being donated.]

37. What are gifts of property held more than one year given to a qualified charity valued at? **(Page 186)**

    a. Cost. [This answer is incorrect. The charitable deduction for ordinary income property, FMV minus the ordinary gain generally results in cost or basis.]

    b. Fair market value unless an automobile is donated and subsequently sold or capital gain property is give to certain types of charities. [This answer is correct. Normally, long-term property is valued at FMV. Several exceptions apply.]

38. In which of the following situations is a charitable deduction reduced by the FMV of goods or services received from the charity? **(Page 187)**

    a. Tom donates $100 to the University of Texas and receives a $25 leather portfolio. [This answer is correct. Tom's $100 deduction is reduced by the value of the leather portfolio.]

    b. Annual membership benefits of $50 per year. [This answer is incorrect. Annual membership benefits up to $75 per year are disregarded.]

    c. A donation to Michigan State University for the right to buy basketball tickets. [This answer is incorrect. In this case, 80% of the donation is deductible.]

EXAMINATION FOR CPE CREDIT

Chapter 10

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

34. Which of the following charitable cash contributions requires substantiation?

    a. A $200 cash donation.

    b. A $250 noncash donation.

    c. All contributions require substantiation.

    d. Do not select this answer choice.

35. Which of the following qualifies as a charitable contribution?

    a. A gift of food and clothing directly to a family in need.

    b. A $20 cash contribution dropped anonymously into the offering plate.

    c. The fair market value of a car which is subsequently sold at auction.

    d. A next-to-new dresser with a FMV of $75 with a receipt from Goodwill Industries.

36. Jane donated a painting worth $50,000 to the Museum of Modern Art, a public charity, to display in the museum. She paid $10,000 for the painting 20 years ago. What amount can she claim as a charitable contribution in 2011?

    a. $10,000.

    b. $50,000.

    c. Only the amount which does not exceed 50% of her adjusted gross income.

    d. None, as the painting is a noncash contribution.

Chapter 11: Deductible Taxes

Learning Objective

Completion of this chapter will enable you to:

- Apply the rules relating to deductible state income or sales taxes, real estate taxes and personal property taxes.

Introduction

Certain income, real estate, and personal property taxes are deductible even though they are not incurred in the taxpayer's trade or business or for the production of income. Such taxes are deductible as itemized deductions. The state and local sales tax deduction, whereby taxpayers can elect to claim an itemized deduction for state and local sales taxes in lieu of deducting state and local income taxes, has been extended through 2011 by the Tax Relief Act of 2010.

Cash-basis taxpayers generally can deduct taxes when they are paid. Prepaid taxes are deductible when paid if there is a reasonable basis for making the payment, and the payment is accepted as an actual payment rather than a deposit.

Taxes deductible as itemized deductions are not deductible in computing alternative minimum tax (AMT). Thus, a large tax deduction on Schedule A may expose the taxpayer to AMT. Carefully timing the payment of state and local income taxes and property taxes can minimize exposure to AMT and maximize the tax benefit of the deductions for these taxes.

State and Local Taxes

Deducting State Income or Sales Taxes

Taxpayers can elect to deduct either state income taxes or state sales taxes paid in 2008. Congress extended the provision allowing taxpayers to claim an itemized deduction for state and local sales taxes in lieu of deducting state and local income taxes through 2011. State and local income taxes are deductible in the year paid by the person upon whom the tax is imposed.

Certain mandatory contributions are deductible, such as contributions to California, New Jersey or New York Nonoccupational Disability Benefit Fund; Rhode Island Temporary Disability Benefit Fund; or Washington State Supplemental Workmen's Compensation Fund.

Penalties and/or interest are not deductible.

Sales Taxes

For 2011, taxpayers can claim an itemized deduction (for regular tax purposes only; not for AMT) for state and local sales taxes *in lieu of* deducting state and local income taxes. The amount of deductible sales taxes is determined by either:

1. Accumulating actual receipts showing general sales taxes paid, or
2. Using IRS tables, which are based on average consumption by taxpayers on a state-by-state basis taking into account filing status, number of dependents, adjusted gross income (plus certain nontaxable items including tax-exempt interest, nontaxable social security, veteran's benefits, worker's compensation, and any nontaxable portion of IRA, pension, or annuity distributions), and rates of state and local general sales tax.

Taxpayers who use the IRS tables can add sales taxes paid with respect to the purchase of motor vehicles (including automobiles, motorcycles, motor homes, recreational vehicles, sport utility vehicles, off-road vehicles, vans, and trucks), boats, aircraft, homes (including mobile and prefabricated homes), and materials to build a home to the amount determined under the table.

IRS Notice 2005-31 makes it very clear that the sales tax must be separately stated and paid by the consumer. This requirement of a separately stated identification of the sales tax can present a problem to many taxpayers with respect to home construction contracts. Often the general contractor incurs the sales tax on the materials and sales tax is not directly imposed on the purchaser of the home. In this case, the sales tax is not deductible by the purchaser.

Also, taxpayers who resided in multiple states during the tax year and who elect to use the optional sales tax tables must multiply the amount determined under the tables for each state of residence by a fraction, the numerator of which is the number of days physically resident in the state and the denominator of which is the number of days in the year. The results for each state of residence are then aggregated to determine the deduction. Practitioners should review Notice 2005-31 and the Schedule A instructions for special rules on using the optional sales tax tables for taxpayers filing jointly who live in separate states and for taxpayers filing married separately.

Claiming the Deduction. To deduct actual expenses, the amount is entered on Form 1040 Schedule A. To compute the deduction using the optional tables, complete the worksheet in the Schedule A instructions (or use the Sales Tax Deduction Calculator at **www.irs.gov**) and enter the amount on Schedule A. See the Schedule A instructions for additional guidance.

Using the Actual Amount of State and Local Sales Taxes Paid. As previously mentioned, taxpayers can deduct the actual amount of general state and local sales taxes paid by accumulating receipts showing sales taxes. The term *general sales tax* means a tax imposed at one rate on the sale at retail of a broad range of classes of items. However, tax on items of food, clothing, medical supplies, and motor vehicles is considered to be general sales tax, even if the tax rate on those items is lower than the general tax rate. If items (other than food, clothing, medical supplies, or motor vehicles) are taxed at a rate other than the general tax rate, no deduction is allowed for the tax on those items. If the tax rate on a motor vehicle is more than the general tax rate, the deduction is limited to the amount of tax on the motor vehicles calculated as if the general tax rate applied.

Sales taxes paid on items used in a trade or business are not included in the deductible amount.

For taxpayers who live in a state with both an income tax and a sales tax, the decision of whether to deduct sales tax versus state income tax should consider the effect of the deduction on state, as well as federal income tax. While most states do not allow a deduction for state income taxes, state sales taxes deducted on the federal return may result in lower state income tax liability.

Effect of Sales Tax on Taxable State Income Tax Refunds. In general, a state income tax refund is taxable only to the extent the payment of those state income taxes in the prior year produced a tax benefit for the taxpayer. For example, a refund is taxable to the extent that the prior year itemized deductions exceeded the prior year standard deduction. As a further limitation, a 2010 state income tax refund received in 2011 is only taxable to the extent the 2010 state income tax deduction actually claimed exceeds the state and local general sales tax deduction that could have been claimed.

Example: State income tax refund limited.

For 2010, Tim deducted $11,000 of state income tax in lieu of a $10,000 sales tax deduction. In 2011, he received a $2,500 state income tax refund. Tim must report $1,000 of the state income tax refund as federal income in 2011 (the excess of the actual state income tax deduction over the available $10,000 sales tax deduction).

Real Estate Taxes. Real estate taxes are deductible in the year paid to the taxing authority by the property owner upon whom the tax is imposed. The taxes must be based on the assessed value of the property and the assessment must be made uniformly on property throughout the community and the proceeds must be used for general public welfare. The deductible tax includes the tenant's share of taxes paid by a cooperative housing corporation. Real estate taxes are deductible for all property owned by a taxpayer. Penalties and/or interest are not deductible. Refunds of real estate taxes paid must be handled carefully. If a refund is received in the same year the tax is paid, net the two against each other on Schedule A; or if the refund is received in a later year, report it as miscellaneous income, subject to the tax benefit doctrine rules.

If the buyer of property pays the seller's delinquent taxes: add to the basis of the property, do not deduct on Schedule A.

Special Assessments. Interest on a special assessment is deductible as real estate tax if based on the specific property on a per-square-footage basis.

Special assessment principal is deductible if it is for maintenance or repairs. Principal is not deductible if it increases the value of the property (i.e., installing a new sidewalk).

Mitigation fees charged for schools, parks, fire districts, etc., which are charged only to parcels which are being developed, are not deductible—they add to the basis of the property.

Personal Property Taxes

State or local personal property taxes are deductible if they meet three qualifying tests:

1. Tax is based on the property's value;
2. Tax is imposed on an annual basis (even if collected more than once per year); and
3. Tax is imposed on personal property, such as automobiles, boats and planes.

Nondeductible taxes include fines (e.g., speeding tickets), license fees (e.g., marriage, dog, drivers, and boats), federal income, excise, social security and custom duties.

Tax on Foreign Income

Tax on foreign income can be deducted on Schedule A or taken as a tax credit on Form 1116. The tax credit usually provides a better tax result.

Deducting Year-end Tax Payments

Cash-basis taxpayers generally can deduct taxes when they are paid. However, real estate taxes paid through the taxpayer's mortgage escrow account are deductible when paid by the mortgage company, not when monthly escrow deposits are made by the taxpayer.

Prepaid taxes are deductible when paid if a reasonable basis exists for making the payment and it is accepted as an actual payment rather than a deposit. Thus, state income taxes withheld from wages and state estimated payments made on a "pay as you go" basis are deductible in the year withheld or paid, as long as the payment is reasonable.

Prepaying deductible tax payments due early in the next year is one way to reduce current-year taxes. However, since taxes are not deductible for alternative minimum tax (AMT), a large tax deduction may expose the taxpayer to AMT and result in no tax benefit for the payment. Time value of money principles should also be considered because prepayments of large amounts of tax will result in the loss of interest on the amounts prepaid.

Chapter 11 Exercise

Question: Real estate taxes.

During 2011, Lonnie paid $1,000 in municipal utility district taxes. The taxes were imposed on all property in the district to pay off revenue bonds used to build and maintain a sewage disposal system. Are the taxes deductible real estate taxes?

Chapter 11 Exercise Solution

Question: Real estate taxes.

During 2011, Lonnie paid $1,000 in municipal utility district taxes. The taxes were imposed on all property in the district to pay off revenue bonds used to build and maintain a sewage disposal system. Are the taxes deductible real estate taxes?

Answer: *Yes. The taxes were levied by a governmental body for the general public welfare at a uniform rate on all the property in the district. Therefore, they are deductible real estate taxes, not a tax charged for local benefits that benefit the property owner. Lonnie can deduct the $1,000 on his 2011 Schedule A.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. Which of the following is correct regarding real estate taxes?

    a. For individual taxpayers, real estate taxes are deductible in the year the taxes are assessed.

    b. If a refund of real estate taxes paid is received in the same year the tax is paid, it is reported as miscellaneous income.

    c. Real estate taxes are deductible for all property owned by the taxpayer.

40. Charlie pays an annual motor vehicle registration fee of 1% of value plus $1 per hundredweight. His fee for 2011 was $134, based on the value of $10,000 and weight of 3,400 pounds. How much, if any, of the registration fee can Charlie deduct on Schedule A of his Form 1040?

    a. $134.

    b. $100.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

39. Which of the following is correct regarding real estate taxes? **(Page 197)**

    a. For individual taxpayers, real estate taxes are deductible in the year the taxes are assessed. [This answer is incorrect. Most individuals are cash-based and deduct taxes in the year in which they are paid.]

    b. If a refund of real estate taxes paid is received in the same year the tax is paid, it is reported as miscellaneous income. [This answer is incorrect. If a refund is received in the same year the tax is paid, the two are netted against each other on Schedule A.]

    c. Real estate taxes are deductible for all property owned by the taxpayer. [This answer is correct. Under current tax law, real estate taxes are deductible for all property owned by the taxpayer, but penalties and/or interest are not deductible.]

40. Charlie pays an annual motor vehicle registration fee of 1% of value plus $1 per hundred-weight. His fee for 2011 was $134, based on the value of $10,000 and weight of 3,400 pounds. How much, if any, of the registration fee can Charlie deduct on Schedule A of his Form 1040? **(Page 197)**

    a. $134. [This answer is incorrect. The portion of the tax based on weight is not deductible.]

    b. $100. [This answer is correct. State or local personal property taxes are deductible if they are based on the property's value.]

EXAMINATION FOR CPE CREDIT

Chapter 11

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

37. How are mitigation fees charged for schools, parks, etc. handled?

    a. They are deductible.

    b. They are added to the property's basis.

    c. Do not select this answer choice.

    d. Do not select this answer choide.

38. Alan's 2011 state income taxes were estimated to be $4,000. The state requires the taxes to be paid in four equal installments of $1,000 on April 15, 2011; June 15, 2011; October 15, 2011; and January 15, 2012. Alan made all the payments when due, except the last one, which was made on December 28, 2011. He made no other state income tax payments in 2011. What is Alan's 2011 deduction for state income taxes?

    a. $4,000.

    b. $3,000.

    c. Depends on the state tax liability for 2011.

    d. Do not select this answer choice.

Chapter 12: Interest Expense

Learning Objective

Completion of this chapter will enable you to:

- Identify the proper classification of interest expense and calculate the allowable deduction for various categories.

Introduction

Interest expense generally must be classified into one of six categories—personal (consumer), trade or business, passive activity, investment, qualified residence, or educational loan. The rules for deducting interest are different for each of these categories. As a result, some means of identifying the use of debt proceeds is necessary to classify the related interest expense.

The regulations provide a system to trace the use of debt proceeds. Once debt proceeds are traced to a particular type of expenditure (i.e., personal, investment, qualified residence, etc.), the related interest expense assumes the character of that expenditure and is treated under the appropriate set of rules.

An exception to the mandatory interest tracing rules applies to qualified home equity indebtedness. Such indebtedness generates fully deductible qualified residence interest regardless of the actual use of the debt proceeds. Another exception relates to the interest expense that pass-through entities incur on debt used to make distributions to owners.

The AMT and regular tax treatment of interest expense may vary.

To summarize, the following three-step process is necessary to determine the tax treatment of an individual taxpayer's interest expense and to report deductible amounts:

1. Categorize the interest expense (personal, investment, trade or business, etc.) using the interest tracing rules (if necessary).

2. Apply the specific rules for the various categories of interest expense to determine the amount that is nondeductible, capitalizable, deductible, or suspended.

3. Report deductible amounts above the line (i.e., on Schedule C, E, F or as educational loan interest) or as an itemized deduction on Schedule A.

Applying the Interest Tracing Rules

General Rules

Under the interest tracing rules of Temp. Reg. 1.163-8T, you must track (i.e., keep records) the use of loan proceeds to determine the type of interest paid. You should separate loan proceeds from other funds whenever possible to avoid IRS reallocation.

Interest Allocation Rules

Loan proceeds can be allocated to expenses paid from any account, including cash, if expenses are paid within 30 days before or after the loan proceeds are deposited in an account (or received in cash).

It is not necessary that actual loan proceeds were used to pay expenses. The 30-day rule applies regardless of other allocation rules.

Interest paid on loan proceeds deposited in an account is treated as investment interest expense. When loan proceeds are withdrawn, the loan must be reallocated based on how the funds were used.

Reallocating Debt

Debt is reallocated when loan proceeds are shifted to a new use. Reallocation occurs when loan proceeds are withdrawn from an account or when an asset is sold and proceeds are not used to pay off debt.

Withdrawing Loan Proceeds from an Account. The order of withdrawing loan proceeds from an account is as follows:

1. If the account has loan proceeds and nonborrowed funds, then loan proceeds come first.
2. If the account has loan proceeds from more than one loan, the earliest loan proceeds come first.
3. If more than one loan is deposited at the same time, the loan first incurred comes first.
4. If the account contains only one loan and related interest, the interest comes first before principal.

Reallocation from Assets Other Than an Account. Debt allocated to assets other than an account is reallocated according to the following rules:

1. Debt is reallocated on the earlier of:
    - The date on which the asset is disposed of and proceeds of the disposition are used for another expenditure, or
    - The date on which there is a change in the use of the asset that causes a reclassification of the first expenditure.
2. The amount of debt that is reallocated is limited to the proceeds from a disposition or the FMV of the asset on the date there is a change in the asset's use.
3. If proceeds from an asset disposition exceed the debt allocated to that asset and proceeds of the disposition are used for more than one expenditure, the debt is allocated among the expenditures by treating the proceeds as an account and using the allocation rules described above.
4. If an asset is sold under an installment contract, debt in excess of the proceeds is allocated to future payments in the order they are to be received. Interest paid on debt allocated to future payments is investment interest.

Allocation of Principal Repayments. When loan proceeds are for mixed use, the principal is treated as repaid in the following order:

1. Personal expenditures;
2. Investment and passive activity expenditures;
3. Rental real estate with active participation;
4. Former passive activities; and
5. Trade or business expenditures.

Example: On January 1, 2011, Stanley borrows $200,000 and immediately uses the proceeds to purchase a duplex. He uses 40% of the duplex as his personal residence and 60% as rental property. The mortgage is at 5% annual interest, payable over eight years.

The following chart shows that Stanley's personal portion of the mortgage is paid off in the fourth year. Until then, the interest applied to the rental portion stays the same, $6,000 each year. Comparing this method to just allocating the interest 40% / 60% each year, the approved method allocates **$10,304 more interest** to the rental activity over the life of the loan. Stanley's taxable social security and AGI would be reduced and his medical and miscellaneous itemized deductions would potentially be increased.

Principal Repayment Schedule								
	1	2	3	4	5	6	7	8
Year	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Overall Loan:								
Begin Bal	200,000	178,399	156,565	133,614	109,489	84,130	57,473	29,452
Payment	30,258	30,258	30,258	30,258	30,258	30,258	30,258	30,256
Interest Paid	8,657	8,424	7,307	6,133	4,899	3,601	2,237	804
Princ. Paid	21,601	21,834	22,951	24,125	25,359	26,657	28,021	29,452
Personal:								
Begin Bal	80,000	58,399	36,565	13,614	0	0	0	0
Interest Paid	2,657	2,424	1,307	133	0	0	0	0
Princ. Paid	21,601	21,834	22,951	13,614	0	0	0	0
Rental:								
Begin Bal	120,000	120,000	120,000	120,000	109,489	84,130	57,473	29,452
Interest Paid	6,000	6,000	6,000	6,000	4,899	3,601	2,237	804
Princ. Paid	0	0	0	10,511	25,359	26,657	28,021	29,452

If Stanley's AGI is high enough, he may not be able to deduct some or all of his real estate losses. That could result in his having a higher current overall tax bill than he anticipated if he had been planning on allocating his interest deduction according to use of the property.

Personal Interest Expense

Categories of Personal Interest

No deduction is allowed for personal interest expense. Personal interest is defined as interest *other than* trade or business interest, investment interest, passive activity interest, qualified residence interest, interest on certain deferred estate taxes, or interest on qualified education loans. Whatever is left is personal interest. To the extent the taxpayer is unable to trace debt to nonpersonal expenditures, debt is presumed to be expended for personal uses. This presumption puts the burden on the taxpayer to document the use of debt proceeds for more favorable expenditure categories.

Under Temp. Reg. 1.163-9T, personal interest includes the following:

1. Interest paid on all underpayments of federal, state, or local income taxes (tax deficiencies) and interest on indebtedness used to pay such taxes (see "Interest Paid on a Tax Deficiency" later in this chapter).
2. Interest paid on the deferred tax liability associated with installment sales of timeshares and residential lots under former IRC Sec. 453C(e)(4)(B). This now applies to interest paid under IRC Sec. 453(l) for the same installment sales, including interest paid by S corporation shareholders relating to installment sales of timeshares within the taxpayer's S corporation.
3. Interest paid by a pass-through entity (trust, S corporation, etc.) on underpayment of state or local income taxes or on debt used to pay such taxes.
4. Interest incurred by employees when loan proceeds are used in connection with their employment (e.g., to purchase a car or computer).

Example: Interest attributable to employee business expenses.

Henry, an outside salesman, is an employee for tax purposes. He must supply his own computer and other equipment, which he deducts as employee business expenses on Form 2106. Henry borrowed money to purchase the computer and other equipment (all of which is used 100% for business). Per IRC Sec. 163(h)(2)(A), employee business interest expense is nondeductible personal interest. Thus, the interest cannot be deducted on Henry's tax return.

Interest Paid on a Tax Deficiency

According to Temp. Reg. 1.163-9T(b)(2), interest paid on an income tax deficiency is nondeductible personal interest regardless of the source of income generating the tax liability. To date, taxpayer attempts to deduct interest paid on tax deficiencies arising from trade or business activities (e.g., Schedule C or F activities) have been unsuccessful *(Allen; Alfaro; McDonnell; Kikalos; Miller; Redlark)*. Given that at least six Circuit courts (the 4th, 5th, 6th, 7th, 8th, and 9th Circuits) and the Tax Court *(Robinson)* have upheld the validity of the regulation there appears to be no authority for the position that interest on an individual income tax deficiency is deductible. However, the Tax Court was divided in *Robinson*, the case that overturned the Court's prior ruling in *Redlark* (where the Tax Court originally held that interest on a deficiency attributable to a trade or business was deductible) so there is still a chance that some taxpayer will again challenge Temp. Reg. 1.163-9T's validity. Practitioners should continue to be alert for developments.

Qualified Residence Interest Expense

Interest paid that arises from a loan such as a mortgage, line of credit, equity loan, deed of trust, or a land contract for which you are legally liable may be deductible. A bona fide debtor-creditor relationship must exist.

You cannot deduct interest paid on behalf of another person. Reg. 1.163-1(b) states in part that "interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his/her indebtedness."

Court Case—Legal Title to Residence Was Held by Brother. Taxpayer paid all expenses of the home and lived there. Court found that taxpayer held the benefits and burdens of ownership and had established equitable and beneficial ownership of the home. Deduction for interest was allowed (*Saffet and Ana Uslu*).

In order for a dwelling to qualify as a residence, it must meet the same rules as under IRC Sec. 121; there must be bathroom facilities, sleeping facilities and kitchen facilities. Definition includes: a house, condo, co-op, mobile home, house trailer or boat.

Points

Interest paid to obtain a home mortgage, known as loan origination fees, loan discount, or discount points, is deductible.

Points are deductible in the year paid if:

1. Secured by the principal residence;
2. Computed as a percentage of the principal amount;
3. Paying points is an established practice in the local area;
4. Taxpayer deposited enough cash into escrow to cover the amount paid as points: if only deposited enough to pay part of the points, then deduct that amount and amortize the balance;
5. The loan was to purchase or build your principal residence; and
6. Points must be clearly identified on the settlement statement.

Taxpayers who meet all the requirements for the deduction may elect to amortize the points over the life of the loan.

Example: In December 2011, Karl buys a new home in the middle of Kansas for $100,000. He pays points of $2,000 (2% of purchase price). After preparing his tax return it is discovered that he does not have enough deductions to itemize. His preparer recommends amortizing the points over the life of the loan.

If the seller pays the points, they are deductible by the buyer in the year paid. The buyer reduces basis in the home by the amount of the points paid by the seller.

Points on second homes are not deductible in the year paid and must be amortized over the life of the loan.

Points on a Refinance. Points paid to refinance are spread over the life of the loan, **unless**:

1. Part of the funds are used to improve your principal residence; and
2. The points otherwise meet the requirements for deductibility stated earlier.

When a refinanced loan is paid off, the remaining points may be deducted in full as long as the new loan is with a different lender.

Example: Jerry refinanced his existing home loan of $300,000 in January 2011 to get a 6.5% loan. He paid points of $6,000. His mortgage broker, Susan, suggested he refinance in July 2011 to get a lower rate of 6.00% at a cost of $5,000, which he did. Can Jerry deduct the entire $6,000 in 2011 and amortize the $5,000 over the life of the new loan?

Yes, providing the second refinance is with a different mortgage lender than the first.

Mortgage Interest Limitations

Qualified Residence Debt. Deductible mortgage interest is limited to the interest on the first $1,000,000 of *qualified debt* on the primary and second residence combined.

Qualified debt is debt used to buy, build or improve a residence, or to acquire a spouse's interest in a divorce.

The debt must be secured by the home and the debt must be recorded or perfected under state law. (Note that wraparound mortgages are NOT considered secured unless they are recorded or perfected under state law.)

You can elect to treat debt as not secured. This election is effective for all subsequent years and can only be revoked with IRS consent. (This election would be beneficial if home mortgage interest is limited and some part of the home equity interest would qualify as business interest, deductible on Schedule C or F.)

Qualified debt cannot be increased by refinancing.

Definition of Principal Residence. Whether a property qualifies as a taxpayer's principal residence depends upon all the facts and circumstances. A houseboat, a house trailer, or a house or apartment a taxpayer is entitled to occupy as a tenant-shareholder in a cooperative housing corporation may qualify as a principal residence. If a taxpayer uses more than one property as a residence, the one that qualifies as the principal residence depends upon all the facts and circumstances. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property the taxpayer uses the majority of time ordinarily will be considered the taxpayer's principal residence.

Second Home. If the taxpayer has several homes in addition to a principal residence, the taxpayer can designate a different home as the second qualified residence each year. The selection can be made on an original or amended return.

Home Equity Indebtedness. Home equity indebtedness is debt secured by a qualified residence. It does not include acquisition debt (i.e., debt used to purchase, construct, or substantially improve the property), which is qualified debt under the $1 million of indebtedness limitation. Home equity debt generates deductible residence interest.

The home equity debt interest deduction is limited to the interest on the lesser of:

1. The fair market value of the home minus the total acquisition indebtedness; or
2. $100,000 ($50,000 for MFS) for the primary and second residence combined.

Home equity loans can be used for any purpose. Even if you pay credit card debt with the proceeds the interest may be fully deductible.

Using a home equity loan to pay off credit card debt may not be a good idea, because it converts short-term debt to long-term debt. In addition, some equity loans are interest only, so they never get paid off.

Other Residential Interest

Refinanced home acquisition debt qualifies only to the extent of the balance of the old mortgage immediately prior to refinancing. The excess may be home equity debt.

Certain other payments also qualify as mortgage interest:

1. Late payment fees, unless they are a collection fee;
2. Prepayment penalties; and
3. Mortgage interest paid by a minister, even when the minister qualifies for a housing allowance.

Mortgage Insurance Premiums

The Tax Relief and Health Care Act of 2006 (TRHCA) created a new itemized deduction for individuals for certain mortgage insurance premiums paid in connection with acquisition indebtedness for a qualified personal residence. The deduction is subject to AGI phase-out rules and is effective for amounts paid or incurred in 2007–2011 (Tax Relief Act of 2010). In effect, these amounts paid for qualified mortgage insurance premiums are treated as a separate category of qualified residence interest.

Investment Interest Expense

Interest paid on money borrowed to buy investment property qualifies for deduction as investment interest. Investment property is defined as:

1. Property that produces interest, dividends, annuities or royalties, not in a trade or business;
2. Property that produces gain or loss from the sale or trade of investment property; or
3. An interest in a trade or business in which the taxpayer does not materially participate.

Investment interest does not include: home mortgage interest, interest from a passive activity, interest that is capitalized, or interest related to tax-exempt interest income.

Investment interest expense is deductible to the extent of net investment income, which is investment income less investment expenses.

Investment income includes interest, dividends, annuities and royalties. Capital gains and qualifying dividends can be considered investment income, if elected.

Excess investment interest expense is automatically carried forward to the following year. The taxpayer has no choice.

Interest Expense on Qualified Retirement Plan Loans

The rules that govern the general deductibility of interest expense under IRC Sec. 163 apply to retirement plan loans. This means the use of the loan proceeds normally determines whether the related interest expense can be deducted. Thus, the interest expense attributable to plan loans used for personal purposes, such as buying a car or going on a vacation, cannot be deducted.

If the plan allows participants to borrow from their accounts to purchase or construct a residence, the interest paid may be deductible as mortgage interest if the plan loan is secured by a recorded deed of trust or a recorded mortgage on the participant's principal residence or second home (this is generally in addition to being secured by the participant's vested plan benefits).

However, in addition to the general deductibility rules of IRC Sec. 163, there are specific deductibility rules for retirement plan loans. Namely, if the borrower is a key employee or the loan is secured by amounts attributable to Section 401(k) or 403(b) elective deferrals, the interest is *not* deductible regardless of how the proceeds are used or how the loan is otherwise secured. For this purpose, a *key employee* is:

1. An officer whose annual compensation exceeds $160,000 (for 2011). Whether an individual is an officer is based on facts and circumstances. Items to consider include the source of authority, the term for which elected or appointed, and the nature and extent of duties.
2. A more-than-5% owner. For corporate employers, this means a person who owns (directly or indirectly) more than 5% of the outstanding stock of the corporation or stock comprising more than 5% of the total combined voting power of all stock of the corporation. For non-corporate employers, this means a person who owns (directly or indirectly) more than 5% of the capital or profits interest in the employer.
3. A more-than-1% owner whose annual compensation exceeds $150,000. For corporate employers, this means a person who owns (directly or indirectly) more than 1% of the outstanding stock of the corporation or stock comprising more than 1% of the total combined voting power of all stock of the corporation. For noncorporate employers, this means a person who owns (directly or indirectly) more than 5% of the capital or profits interest in the employer.

In determining ownership under items 2–3, the attribution rules of IRC Sec. 318 must be considered. Also, compensation, for purposes of items 1–3, is grossed up to include the elective or salary reduction contributions to cafeteria plans, cash and deferred arrangements [e.g., 401(k) and SIMPLE plans], and tax-sheltered annuities.

Retirement plan loans can be treated as income in the year the loan is made unless the loan meets certain criteria under IRC Sec. 72(p). Also, even if the loan meets the criteria for nondistribution treatment when it is originated, the unpaid balance can be considered a taxable distribution in any year the borrower defaults on the loan terms.

Chapter 12 Exercise

Question: Points paid when purchasing a principal residence.

Rick and Rhonda Rose took out a $100,000 mortgage loan to buy a home in December. They were charged a 1% ($1,000) loan origination fee, which was designated as one point on the closing statement. They meet all the requirements for deducting points in the year paid, and paid $1,200 at closing, which was not allocated to any particular closing costs. Additionally, the sellers who sold the Roses the home paid one point ($1,000) to help them get their mortgage. How much in points, if any, can the Roses deduct on their income tax return for the year?

Chapter 12 Exercise Solution

Question: Points paid when purchasing a principal residence.

Rick and Rhonda Rose took out a $100,000 mortgage loan to buy a home in December. They were charged a 1% ($1,000) loan origination fee, which was designated as one point on the closing statement. They meet all the requirements for deducting points in the year paid, and paid $1,200 at closing, which was not allocated to any particular closing costs. Additionally, the sellers who sold the Roses the home paid one point ($1,000) to help them get their mortgage. How much in points, if any, can the Roses deduct on their income tax return for the year?

Answer: *The $1,000 in points the Roses were charged is deemed paid and is deductible. In addition, the Roses can deduct the $1,000 point paid by the seller, provided they reduce their basis in the home by $1,000. Thus, their total Schedule A deduction for mortgage points is $2,000.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

41. Nondeductible personal interest expense is defined as:

    a. Interest paid on individual tax deficiencies.

    b. Any interest that cannot be defined as interest under one of the other categories.

42. Mel and Melanie Martin have acquired three homes burdened by mortgage debt: the city house (their principal residence)—$300,000, the beach house—$200,000, and the ski condo—$150,000. All proceeds from the mortgage debt were expended solely on the residences. Which mortgages qualify for the Qualified Residence deduction?

    a. Only the mortgages on the principal residence and one other residence.

    b. The taxpayers will use the first two acquired for purposes of determining the qualifying mortgages.

43. Tim refinanced his $150,000 mortgage on his principal residence at a lower interest rate in 2011. All of the proceeds of the new loan were used to pay off the old loan. Which of the following is true regarding the interest on the new loan?

    a. The interest on the entire new mortgage is qualifying home residence acquisition indebtedness.

    b. None of the interest is deductible as it was refinanced.

44. Clinton has one $100,000 home equity line of credit which was incurred for two purposes. $50,000 was incurred to remodel the kitchen of his principal residence and the other $50,000 was to pay off some personal credit cards. What is the appropriate treatment of his 2011 interest expense of $5,400?

    a. Clinton must allocate the interest expense 50% to home equity interest and 50% to personal interest over the life of the loan.

    b. Clinton must allocate the interest expense 50% to home equity interest and 50% to the personal interest but as the loan is paid, he is deemed to pay off the personal portion first.

    c. Clinton may deduct the full amount of interest as home equity interest expense and none of the interest is considered “qualified residence” interest expense.

    d. Clinton may deduct 50% of the interest expense as home equity interest expense and 50% of the interest expense as “qualified residence” interest expense.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

41. Nondeductible personal interest expense is defined as: **(Page 208)**

    a. Interest paid on individual tax deficiencies. [This answer is incorrect. While this is personal interest, it is not the definition of personal interest. Personal interest is defined as interest *other than* trade or business interest, investment interest, passive activity interest, qualified residence interest, interest on certain deferred estate taxes, or interest on qualified education loans.]

    b. Any interest that cannot be defined as interest under one of the other categories. [This answer is correct. Personal interest is defined as interest *other than* trade or business interest, investment interest, passive activity interest, qualified residence interest, interest on certain deferred estate taxes, or interest on qualified education loans.]

42. Mel and Melanie Martin have acquired three homes burdened by mortgage debt: the city house (their principal residence)—$300,000, the beach house—$200,000, and the ski condo—$150,000. All proceeds from the mortgage debt were expended solely on the residences. Which mortgages qualify for the Qualified Residence deduction? **(Page 210)**

    a. Only the mortgages on the principal residence and one other residence. [This answer is correct. Under current tax law, the Martins can treat the interest from the mortgages on only their principal residence and one other residence as qualified residence interest. They can select one of the vacation homes to be treated as a qualified residence each year, and the selection can be changed from year to year. The interest expense from the third residence is treated as nondeductible personal interest.]

    b. The taxpayers will use the first two acquired for purposes of determining the qualifying mortgages. [This answer is incorrect. The order in which the residences were acquired is irrelevant.]

43. Tim refinanced his $150,000 mortgage on his principal residence at a lower interest rate in 2011. All of the proceeds of the new loan were used to pay off the old loan. Which of the following is true regarding the interest on the new loan? **(Page 210)**

    a. The interest on the entire new mortgage is qualifying home residence acquisition indebtedness. [This answer is correct. Refinanced home acquisition debt qualifies to the extent of the balance of the old mortgage immediately prior to refinancing.]

    b. None of the interest is deductible as it was refinanced. [This answer is incorrect. Refinanced home acquisition debt qualifies as deductible interest under current tax law.]

44. Clinton has one $100,000 home equity line of credit which was incurred for two purposes. $50,000 was incurred to remodel the kitchen of his principal residence and the other $50,000 was to pay off some personal credit cards. What is the appropriate treatment of his 2011 interest expense of $5,400? **(Page 211)**

    a. Clinton must allocate the interest expense 50% to home equity interest and 50% to personal interest over the life of the loan. [This answer is incorrect. Clinton is not required to trace the proceeds of a home equity loan not exceeding $100,000.]

    b. Clinton must allocate the interest expense 50% to home equity interest and 50% to the personal interest but as the loan is paid, he is deemed to pay off the personal portion first. [This answer is incorrect. The personal portion is considered paid first but the total amount of the loan does not exceed $100,000 and does not require allocation.]

    c. Clinton may deduct the full amount of interest as home equity interest expense and none of the interest is considered "qualified residence" interest expense. [This answer is incorrect. The portion used for the remodel of the kitchen is considered "qualified residence" interest expense.]

    d. Clinton may deduct 50% of the interest expense as home equity interest expense and 50% of the interest expense as "qualified residence" interest expense. [This answer is correct. The portion of the loan used for the remodel is considered "qualified residence" interest expense as it is considered part of the cost of acquisition. This will only make a difference for AMT purposes.]

EXAMINATION FOR CPE CREDIT

Chapter 12

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

39. Nondeductible personal interest includes all of the following **except:**

    a. Interest paid on credit cards used for personal expenditures.

    b. Interest paid on a pontoon acquired to use at a lake house.

    c. Interest paid on $25,000 home equity loan used to purchase personal auto.

    d. Interest paid on individual income tax liabilities.

40. Which of the following is **not** a factor in determining if interest on a debt is "Qualified Residence Interest Expense"?

    a. It must be for property that qualifies as a dwelling.

    b. It must not exceed $100,000.

    c. It must be secured by the residence.

    d. Do not select this answer choice.

41. Which of the following qualifies as mortgage interest?

    a. Prepayment penalties.

    b. Collection fees.

    c. Points paid on a refinance.

    d. Interest paid on a tax deficiency.

42. Interest expense on qualified retirement plan loans is treated as:

    a. Nondeductible personal interest if used to pay credit card debt.

    b. Nondeductible.

    c. Deductible if used to remodel a residence with or without the home used as security.

    d. Follows the general interest tracing rules for key employees.

Chapter 13: Other Itemized Deductions

Learning Objective

Completion of this chapter will enable you to:

- Identify other allowable itemized deductions and apply limits as required.

Introduction

The majority of expenses allowed as itemized deductions are governed under specific Code provisions such as taxes, interest, and charitable contributions. However, other expenses that are personal in nature are deductible if incurred in connection with the production of income. These miscellaneous itemized deductions include such items as employee business expenses, investment expenses, certain education expenses, and certain accounting and legal fees.

Once it is determined that an expenditure is allowed as a deduction, further limitations may apply that bear no relation to the expenditure. The most encompassing limitation is the 2% of AGI limitation (applicable to most miscellaneous itemized deductions) and the 3% of AGI/80% of itemized deduction phase-out for higher incomes.

For 2010, 2011, and 2012, there is NO overall itemized deduction phase-out (Tax Relief Act of 2010).

Starting in 2013, the phase out is scheduled to return. Under this rule, itemized deductions, other than those specifically excluded, are reduced by 3% of the amount that AGI exceeds these thresholds. Casualty losses, medical expenses, investment interest, and gambling losses to the extent of gains are excluded from these phase-out requirements. The reduction is limited to a maximum of 80% of otherwise allowable deductions, not counting the excluded deductions. The phase-out rules apply *after* considering the 2% of AGI floor for miscellaneous itemized deductions and other limitations on deductions. The deduction for personal casualty losses is another area where additional deduction limitations are applicable.

In general, miscellaneous itemized deductions subject to the 2% of AGI floor are not deductible in computing the alternative minimum tax (AMT). However, miscellaneous itemized deductions that are subject to the 2% of AGI floor are not deductible in computing the AMT. Thus, a large miscellaneous deduction on Schedule A (which must be added back to income in computing AMT) may expose the taxpayer to AMT.

When miscellaneous deductions can be properly allocated to an “above-the-line” activity, such as a Schedule C proprietorship, Schedule E rental activity, or Schedule F farming activity, the 2% of AGI limitation and the phase-out of itemized deductions do not apply. In addition, above-the-line treatment is preferable because such deductions reduce AGI (thereby increasing AGI-sensitive deductions and credits), are deductible for AMT, and, if allocable to Schedule C or F, reduce self-employment income (and thus SE tax). Generally, tax preparation and certain other professional fees are miscellaneous itemized deductions subject to the 2% of AGI floor. However, professional fees directly related to a business activity are fully deductible as business expenses under IRC Sec. 162. In Rev. Rul. 92-29, the IRS ruled that tax preparation fees and expenses incurred in resolving asserted tax deficiencies relating to the taxpayer’s trade or business are deductible “above-the-line” on Schedule C, E, or F.

Deducting Personal Casualty Losses

Definition of a Casualty

A *casualty* is a sudden, unexpected, or unusual event that results in actual physical damage. Sudden events are swift, not gradual or progressive. Unexpected events are ordinarily unanticipated and unintended. Unusual events are not day-to-day occurrence and are not typical of the activity engaged in.

IRS Pub. 547 provides a list of deductible casualty losses resulting from causes such as, but not limited to: earthquakes; floods; storms, including hurricanes and tornadoes; terrorist attacks; vandalism; government-ordered demolition or relocation of a home that is unsafe because of a disaster; shipwrecks; sonic booms; volcanic eruptions; and certain car accidents and fires.

IRS Pub. 547 also provides a list of nondeductible casualty losses resulting from causes such as, but not limited to:

- A fire or car accident, if caused by the taxpayer’s willful negligence or willful act. The same is true if someone acting for the taxpayer caused the incident.
- Accidental breakage under normal conditions.
- A family pet.
- Progressive determination such as drought, termite or ant damage, or steady weakening of a building due to normal weather or wind.

Amount of Deduction

The deduction under IRC Sec. 165(a) is limited, in the case of losses of an individual, to the following:

- Losses incurred in a trade or business;
- Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- Losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck or other casualty, or other theft.

This chapter focuses on losses addressed by IRC Sec. 165(c)(3), namely individual losses not associated with a for-profit motive.

The basis for determining the amount of the deduction for any loss shall be the adjusted basis of the property as provided under IRC Sec. 1011 for determining the loss from the sale or other disposition of property.

The loss is the decrease in the fair market value before and after the casualty, but the loss cannot exceed the adjusted basis of the property.

Reg. 1.165-7(a)(2) provides for two methods of valuing a casualty loss—the decrease in fair market value or the cost of repairs. To be eligible for a casualty loss deduction based on the decrease in the fair market value, a taxpayer must prove the fair market value of the property immediately before and immediately after the casualty.

Good evidence is necessary to determine the resulting decrease in FMV. Consider obtaining appraisal reports expert testimony etc. to corroborate the basis for the FMV(s).

In determining the amount of loss deductible, the fair market value of the property immediately before and immediately after the casualty shall be ascertained by appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction shall be limited to the actual loss resulting from damage to the property.

The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that:

- Repairs are necessary to restore the property to its condition immediately before the casualty,
- Amount spent for such repairs is not excessive,
- Repairs do not care for more than the damage suffered, and
- The value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

Must the repairs actually be made? Case law says a resounding “Yes!” Taxpayers have been struck down where estimates rather than the actual cost of repairs have been used in claiming the deduction (*Clapp v. Comm.* and *Robin E. Schmidt v. Comm.*).

Limitation on Loss. An individual’s loss shall only be allowed to the extent that the amount of loss arising from each casualty (or theft) exceeds $100.

An individual’s net casualty loss is allowed first to offset any personal casualty gains for the tax year, and then only to the extent that the excess exceeds 10% of the adjusted gross income of the individual. IRC Sec. 165(h)(3) provides that a personal casualty gain is the gain from any involuntary conversion of property arising from fire, storm, shipwreck, or other casualty, or from theft.

The loss is determined after considering insurance or other reimbursements. A timely insurance claim must actually be filed with the insurance company, or no casualty loss will be allowed.

Timing of Deduction

Generally, a loss under IRC Sec. 165(a) shall be allowed as a deduction only for the taxable year in which the loss is sustained. Like many areas in the tax law, there is no bright-line test here. Rather, the taxable year in which the loss is sustained will be determined by an individual taxpayer’s unique set of facts and circumstances.

If a qualifying casualty loss, and in the year of such casualty, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is deductible until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

If a portion of the casualty loss is not covered by a claim for reimbursement, then that portion of the loss is allowed during the taxable year in which the casualty or other event took place.

What happens if the taxpayer deducted a loss as described above, and in a subsequent taxable year receives reimbursement for such loss? Such reimbursement is included in income for the taxable year in which it was received, subject to the tax benefit rule.

If the eventual reimbursement turns out to be less than expected, a loss can be claimed in the year it is determined the taxpayer cannot reasonably expect any further reimbursement. Note that the original return is not amended. The additional loss is treated as if sustained in the year of settlement and is included with any other casualty losses for that year.

Reporting

Use Form 4684 (Casualties and Thefts) to calculate the taxpayer's casualty-loss deduction. A personal casualty loss is ultimately reflected as an itemized deduction on Schedule A.

Theft Losses

Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred and it must have been done with criminal intent. This may include:

> Blackmail, burglary, embezzlement, extortion, kidnapping for ransom, larceny, robbery and fraud or misrepresentation, if it is illegal under state or local law.

A taxpayer is not entitled to a theft deduction if the taking of money or property occurred with the taxpayer's full knowledge and the taxpayer in effect condoned the taking (*Ing, Richard v. U.S.*). Interestingly, payments to his mistress to keep her from revealing their extramarital affair is not exactly on par with payments for a kidnapping to save one's life.

A theft loss deduction is calculated in the same manner as the casualty-loss deduction. For purposes of the calculation, the fair market value of the property immediately after the theft is deemed to be zero. The two limitations under IRC Sec. 165(h)—the $100 limitation and 10% AGI floor—also apply.

Resources on identity theft and other theft issues may be found at:

- IR-2009-71, IRS Alerts Public to New Identity Theft Scams
- IR-2008-11, IRS Warns of New E-Mail and Telephone Scams Using the IRS Name; Advance Payment Scams Starting
- **www.occ.treas.gov**

Losses arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss. The year of discovery is the year in which a "reasonable person" in similar circumstances would have discovered the fact of the theft loss (*Cramer v. Comm.*).

Ponzi Schemes. Victims of a Ponzi scheme (such as the one perpetrated by Bernie Madoff) are entitled to deduct their losses as a theft deduction reported on Schedule A. A theft loss can be taken in the year discovered.

Disaster Losses

A disaster loss is a 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.

The FEMA website, **www.fema.gov**, has full details on disasters. Go to Disaster Information and Declared Disasters by Year or State. For the year 2009, there were 49 federally declared disasters reported on the website by November 30. During 2008, there were a total of 75.

A disaster loss deduction is calculated in the same manner as the casualty loss deduction. The valuing of property subsequent to a disaster can be tricky. To address this, IRC Sec. 165(i)(4) states that nothing shall be construed to prohibit the Secretary from prescribing regulations or other guidance under which an appraisal for the purpose of obtaining a loan of federal funds or a loan guarantee from the federal government as a result of a Presidential declared disaster may be used to establish the amount of the disaster loss. Regulations have not yet been prescribed.

At the taxpayer's election, the loss may be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred. If an election is made under IRC Sec. 165(i)(2), the casualty resulting in the loss is treated as having occurred in the taxable year for which the deduction is claimed.

The election to deduct the disaster loss in the preceding year is made by filing a return, an amended return, or a refund claim that clearly shows that the election is being made. The election pertains to the entire loss sustained by the taxpayer in the disaster area during the disaster period. For example, when Hurricane Dolly struck Texas, many counties were declared a disaster area beginning July 22, 2008. Simply stated, the election to amend the prior year return or claim in the year of casualty, must be made by the un-extended due date of the tax return for the year of the loss.

Tip: The IRS has recommended stating on the front of a return (e.g., 1040, 1040X) that the refund claimed is due to a disaster loss. Expedited processing should result.

The election should contain a description of the disaster, the date(s) the event took place, and the city, town, county and state where destroyed property was located.

Example Election:

Election to Claim Early Disaster Loss under IRC Sec. 165(i)

Taxpayer(s)   Social Security Number(s)

The above named taxpayer(s) elect to claim a disaster loss deduction for the calendar year 20XX [year proceeding loss year] pursuant to IRC Sec. 165(i). The disaster that destroyed our house consisted of YYY that occurred during the period Month, XXX [loss year]. At the time of the disaster, the house was located in ZZZ.

Taxpayers have 90 days in which to change their minds and revoke the election under the IRC Sec 165(i). After that 90-day period, the election becomes irrevocable.

Considerations in choosing the year in which to take the disaster loss include the following:

- The client's need for cash. A disaster occurring in 2011 will produce immediate cash flow in the form of a refund for an amended (2010) return. This is far faster than waiting until the 2010 filing season.
- Tax bracket and taxable income for each year. The numbers should be run in both years, as everyone's situation is unique.
- Adjusted gross income in both tax years, due to the IRC Sec. 165(h)(2) limitations.
- Ability to generate NOLs from a casualty loss and the resulting carryback period. A current disaster loss (2011) can be claimed in 2011 or 2010. A taxpayer who claims a disaster loss in 2011 and generates an NOL may carry the claim back to 2008 (three years). A taxpayer who experiences a disaster loss in 2011 but elects to report the loss in 2010 under IRC Sec. 165(i) may carry the NOL claim back to 2007.

A taxpayer can elect under IRC Sec. 1033, to defer gains realized from involuntary conversions of property resulting from destruction, theft, seizure, condemnation, or threat of condemnation Under IRC Sec. 121(d)(5), an involuntary conversion of a residence is treated as a sale, eligible for the Section 121 gain exclusion. For Section 1033 purposes, the amount realized from the conversion is reduced by the gain excluded under IRC Sec. 121. Also, IRC Sec. 1033(h) provides several benefits, including an exclusion for unscheduled personal property, grouping of other proceeds as a common fund, expanded definition of a residence, and extended replacement period.

In Chief Counsel Advice 200734021, the IRS says that a home must be totally destroyed for gain on a deemed sale of the property (e.g., because insurance proceeds exceed its basis) to be excluded under IRC Sec. 121 home sale exclusion rules. The CCA also concludes that a disaster damaged home that must be torn down before it can be rebuilt at a cost exceeding its pre-disaster value qualifies as destroyed.

Insurance reimbursements for living expenses following the occurrence of a casualty to a taxpayer's principal residence are accounted for independently of the casualty loss computation. The taxpayer must report as taxable income any insurance reimbursements that cover normal living expenses. However, payments that cover increased temporary living expenses are not taxable income. See also Rev. Rul. 93-43 for timing of the determination.

Deducting Job Search Expenses

Qualifications for Deductible Expenses

Expenses incurred by the taxpayer when searching for new employment in the same trade or business are deductible. However, costs of searching for a job in a new or different trade or business are not deductible, even if employment is obtained as a result of the search. Qualifying expenses are deductible even if the taxpayer is unsuccessful in obtaining employment, or decides not to accept a new position that is offered.

Same Trade or Business. The determination of what constitutes the same trade or business focuses on the nature of the employment (i.e., types of duties performed) rather than the taxpayer's status as an employee or self-employed. Thus, a taxpayer (CPA) working as an

employee for a CPA firm could deduct expenses incurred in seeking employment as a self-employed CPA or in some other accounting capacity as an employee.

Job search expenses are not deductible if the taxpayer is seeking employment in a new field unrelated to services previously performed because those expenses are attributable to a new trade or business. A self-employed artist was denied deductions for expenses incurred in seeking to open an art gallery. The Tax Court held this was a new trade or business because the taxpayer was going from actually producing the artwork to merchandising it in the business arena for the first time *(Murata)*.

Temporary Employment or Temporary Unemployment While Searching. Expenses incurred during temporary employment in a different line of work can still be deductible. A plumber temporarily working as a pipefitter was allowed to deduct daily transportation expenses incurred for traveling to his union hall to seek employment as a plumber. The Tax Court ruled that he had not abandoned his trade or business as a plumber because of his temporary employment while seeking work in his current trade *(Charlton)*.

If a taxpayer is temporarily unemployed, his trade or business consists of the services previously performed for the past employer. This allows a deduction for expenses incurred seeking reemployment during a period of temporary unemployment, but only if there is not a substantial lack of continuity between the time of the past employment and the seeking of new employment. The IRS has viewed this "substantial lack of continuity" to exist after a period of one year. However, the Tax Court has taken a more facts and circumstances approach in attempting to distinguish between expenses incurred during a temporary period of transition (deductible) versus expenses made "in anticipation of resuming business at some indefinite future time" (nondeductible). This could range as high as three years in some cases *(Picknally)*.

Example: Job search expenses while unemployed.

Tim was working as a mechanical engineer when he was laid off in January 2011. In October 2011, he decided that his former employer was not going to rehire him, so he began looking for an engineering job with another company. He traveled to other cities in the same state for several scheduled interviews. He also updated his resume with a professional agency. In December, he accepted an offer with another firm as their chief mechanical engineer. Tim's travel expenses and his agency fees for updating his resume would be deductible as job search expenses. The 11-month period of unemployment would not be considered a "substantial lack of continuity."

An unemployed taxpayer expecting significant downtime in employment should maintain a diary and other documentation to substantiate and corroborate the efforts made to find employment in the previous trade or business (e.g., daily calendar; copies of telephone bills and other necessary receipts to establish the amount, time and place, and business purpose of the expenditures).

Deductible Expenses and Where to Deduct Them

Deductible job search expenses are a miscellaneous itemized deduction. Therefore, they are deductible only for regular tax purposes and only to the extent they and other miscellaneous itemized deductions exceed 2% of AGI. Also, they are subject to the 3% AGI phase-out for certain itemized deductions starting in 2013. Remember, under current law there is **no** 3% phaseout in 2010, 2011, and 2012.

Examples of deductible job search expenses include employment agency fees, resume preparation expenses, and travel and transportation expenses. Additional expenses that may be deductible as job search expenses include employment counseling fees, postage, typing and printing, and advertising *(Avery)*. However, the costs of finding first-time employment are not deductible, since first time employment by definition cannot be in the taxpayer's same trade or business. But, moving expenses associated with first-time employment are deductible.

Travel Expenses. Local transportation expenses to attend scheduled interviews for a possible job in the taxpayer's same trade or business are deductible, as well as travel expenses to attend scheduled interviews in various other cities. However, if a taxpayer travels to another city and engages in both personal and job searching activities, the travel expenses to and from the destination are deductible only if the primary purpose of the trip is to search for a new job. The "primary purpose" depends on the facts and circumstances of each particular case *(Solati)*. The amount of time spent on personal activities compared to the amount of time spent in looking for work is important in determining whether the trip is primarily personal or is primarily to look for a new job.

The rule that the primary purpose of the trip must be to search for a new job applies only to the travel expenses to and from a destination. Thus, even if these travel expenses are not deductible (because of too many personal activities), expenses of searching for a new job while in the area are deductible. The standard mileage rate ($ .51 per mile for 2011) can be used to compute automobile expenses.

Example: Job search travel expenses.

After losing his job in January 2011, Bob decided to visit his sister Janet and relax a little. He drove 200 miles (one way) to see her. During his two-week stay, he regularly played golf and tennis and saw some old friends. On two different days, he interviewed at an employment agency and later paid them a fee to help him find a job there in his previous field. He also incurred some expenses to update his resume for the agency.

Bob is unable to deduct his travel expenses for driving to see his sister, even though he incurred some legitimate job search expenses while there. The primary purpose of his trip was clearly personal. However, the employment agency fee and the resume updating expenses would be deductible.

Variation: Assume the same facts except that Bob spends every weekday interviewing and looking for job placement during his stay. He plays golf only on the weekends. He spends the vast majority of his time looking for work and little time on personal activities, even though staying with his sister and enjoying her company. The primary purpose of his trip is to search for a job, therefore allowing him to deduct his travel expenses of $200 (400 miles × $ .51 per mile) in addition to the agency fee and resume expenses.

Deducting Employee Business Expenses

Generally, employee business expenses are reported on Form 2106, and are claimed as itemized deductions subject to the 2% of adjusted gross income (AGI) limitation on Schedule A, line 21.

Reasons why employees file Form 2106 include the following:

- To claim deductions for unreimbursed vehicle, travel, transportation, meals, entertainment and other job-related expenses.

- If the employer made any reimbursements, in order to claim any expenses in excess of the reimbursement.
- If the employer reimbursed expenses for a vehicle for which the taxpayer claimed actual expenses in the first year placed in service, or any prior depreciation other than straight line (SL).

Form 2106 should not be filed if:

- Claiming only job-related deductions other than for vehicle, travel, transportation, meals or entertainment, if no reimbursements by employer (education, business use of home, dues, etc.). Enter such expenses directly on line 21 of Schedule A.
- Employer reimbursements are equal to employee business expenses, unless actual expenses for a vehicle were claimed in a prior year.
- Expenses are not deductible because of 2% of AGI limitation, if otherwise not required to file.

File Form 2106-EZ if there are no employer reimbursements (amounts included in box 1 of Form W-2 are not considered reimbursements), and the standard mileage rate is used to claim any vehicle expenses.

Special rules apply to individuals with a physical or mental disability or impairment that functionally limits their activities as an employee. Expenses necessary to perform work satisfactorily, for goods or services not required by the employer or used personally (other than incidentally), and not specifically covered under other tax laws are miscellaneous itemized deductions not subject to the 2% of AGI floor. Examples include a reader for a blind employee and attendant care at the work place. Impairment-related expenses are reported on line 28 of Schedule A not subject to the 2% of AGI floor.

Deducting Work-related Educational Expenses

Qualified educational expenses are deductible if they meet at least one of the following tests:

1. The education is expressly required by the employer or required by law or regulations for the employee to retain their current employment relationship, status or compensation level.
2. The education maintains or improves skills required in the individual's current employment, trade or business.

See flowchart entitled "Does Your Work-Related Education Qualify?" in IRS Pub. 970.

Qualified educational expenses include tuition, books, supplies, lab fees, and, in some cases, transportation expenses.

Example: Laura's acting career was going nowhere. She took two courses on movie job creation at the local accredited college. Assuming Laura is a sole proprietor, deducting the cost of the courses as a current business deduction would save federal and Medicare taxes, and possibly social security, state, and local taxes.

Qualified education expenses are deducted on Schedule C or F for the self-employed and as a miscellaneous itemized deduction subject to the 2%-of-AGI limit for employees.

Court Case: Daniel Allemeier was hired as a salesperson for a removable orthodontics maker in 1996. He excelled in his job and was given additional responsibility including marketing strategy, seminar promotion and more. Daniel decided to pursue an MBA in 1999 to continue his advancement and enhance his skills. The MBA was not required by his employer but was suggested by the company CEO. During the MBA years, Daniel kept getting promotions which expanded his company role. In 2001, he received his MBA. He deducted his MBA expenses as an itemized deduction subject to the 2% limit. The IRS disallowed the deduction and slapped on a 20% accuracy related penalty.

Tax Court Findings: The court agreed with the taxpayer. They reviewed his tasks before and after the MBA. The basic nature of his duties did not change before and after the MBA. He was being consistently promoted before the MBA. The MBA did not qualify Daniel for a new trade or business rather it accelerated his natural career path (*Allemeier, Daniel R. Jr.,* TC Memo 2005-207).

Expenses Must Not Qualify Taxpayer for a New Trade or Business

Education that qualifies the taxpayer for a new trade or business is not deductible as a work-related expense. Expenses of education that qualify a taxpayer to enter a new trade or business are nondeductible, regardless of whether the taxpayer actually enters that trade or business (*Bodley*). The tasks the taxpayer is qualified to perform before the education are compared to those for which he is qualified after the education to determine whether the education enabled him to enter a new trade or business (*Weiszmann*).

In one situation, a practicing accountant deducted his expenses incurred in pursuing a legal education to improve his accounting skills and obtain a law degree. The court ruled that the fact the taxpayer neither practiced nor intended to practice law was irrelevant; the deductions were nondeductible under the regulations (*O'Donnell*). The Tax Court reached the same conclusion in *Udoh* when an insurance salesman incurred law school expenses. The expenses qualified the taxpayer for a new trade or business in the practice of law. Likewise, law school expenses were not deductible by an individual who worked as a law clerk while earning his degree (*Weyts*). The court found that clerking and practicing as a lawyer were two different trades or businesses. Similarly, an aeronautical engineer was unable to deduct his flight school expenses. Although the training improved his aeronautical engineering skills, it also qualified him to enter a new field as a commercial pilot (*Thompson*). (Such expenses, however, may be eligible for either the hope credits, lifetime learning credits, or the tuition deduction.)

Deducting Gambling Losses

Gambling losses include losses from all types of wagering transactions, including casino gambling, bingo, and lotteries. In *Tschetschot*, the Tax Court ruled that tournament poker does constitute gambling, rather than an "entertainment or professional sports" activity, and is subject to the gambling loss limitations. Several tax issues arise when taxpayers incur gambling losses. These include reporting requirements, deduction limitations, and loss substantiation.

Reporting Gambling Losses

Where gambling losses are reported on Form 1040 depends on whether the taxpayer is in the trade or business of gambling. While most individuals are not professional gamblers, the Supreme Court ruled in *Groetzinger* that an individual could be in the trade or business of

gambling (i.e., a professional gambler) if he pursued gambling full-time, in good faith, with regularity, and as a livelihood rather than as a hobby. In that case, the taxpayer had no other employment and gambled full-time at pari-mutuel dog racing. The Court found that his activity required skill, which he applied, and was more than a mere hobby. In *Castagnetta*, the taxpayer held a part-time job in addition to spending about 40 hours per week carrying on his gambling activity (horse racing). Even though the taxpayer was employed part-time in a job unrelated to gambling, the Tax Court held that the amount of time devoted to his gambling qualified this activity as a trade or business. Consequently, the taxpayer can deduct his gambling losses on Schedule C as business expenses and not on Schedule A as miscellaneous itemized deductions.

When a taxpayer can claim gambling as a trade or business, the income and loss is reported on Schedule C *(Rusnak)*. For all other taxpayers (amateur gamblers), gambling winnings are reported as "other income" on line 21 of Form 1040, and gambling losses are reported on Schedule A as miscellaneous itemized deductions. (They are not netted against each other.) Gambling losses claimed as miscellaneous itemized deductions are not subject to the 2% of AGI floor or to the 3% of AGI overall phase-out for itemized deductions. Gambling losses are also deductible in calculating AMT. However, nonprofessional gamblers that do not itemize deductions lose the tax benefit of deducting their losses against winnings.

Whether a taxpayer's gambling rises to the level of a trade or business depends on the facts. Numerous court cases have dealt with this issue, and taxpayers generally lose. Few taxpayers are likely to gamble to the extent required to treat the activity as a trade or business.

Gambling Loss Deduction Limited

IRC Sec. 165(d) provides that taxpayers can deduct gambling losses only to the extent of gambling gains. The courts have ruled that this limitation applies even if the taxpayer is in the trade or business of gambling because the more specific rule of IRC Sec. 165(d) overrides the general deduction rule of IRC Sec.162(a) *(Praytor; Valenti; Kent)*. According to these courts, in the *Groetzinger* case, the Supreme Court ruled only on the issue of engaging in a trade or business and did not address the interplay between IRC Sec. 165(d) and IRC Sec. 162(a). Thus, there is no distinction between professional gamblers and occasional, amateur gamblers when it comes to the deductibility of gambling losses. The losses need not be from the same type of gambling to offset winnings (e.g., losses from wagering on horse racing can offset gains from lottery winnings) *(Drews)*.

Professional gamblers can deduct ordinary and necessary business expenses in addition to their wagering losses. However, these expenses are treated as gambling losses, so a professional gambler's combined wagering losses and trade or business expenses cannot exceed gambling winning under IRC Sec. 165(d) *(Kozma)*. The additional expenses incurred by a professional gambler may be deductible as a trade or business expense under IRC Sec. 162. However, the activity as a whole cannot generate a loss for the taxpayer and the Schedule C cannot provide a negative amount carried to Form 1040, Page 1. Any excess gambling losses over gambling winnings cannot be carried forward or carried back to offset gambling winnings from other tax years. These excesses are abandoned.

When a joint return is filed, the combined gambling losses of the spouses are allowed to the extent of their combined gambling gains. The Tax Court has ruled that the value of complimentary rooms, vacations, and other gifts a casino provides a taxpayer must be reported as taxable income but can be included in gambling gains and offset by allowable gambling losses *(Libutti)*.

What Qualifies as Gambling Losses? For the nonprofessional gambler, the Tax Court has generally held that only the cost of a wagering transaction is treated as a gambling loss *(Whitten)*. Additional expenses to engage in wagering are not gambling losses. Thus, expenses for travel, meals, and lodging do not qualify as gambling losses. Unless the taxpayer is a professional gambler, these additional expenses generally are treated as nondeductible, personal expenses. The IRS stated that such expenses cannot be deducted under IRC Sec. 212 as incurred for the production of income because amateur gamblers do not have a bona fide expectation of profit, given how the odds are known to favor the house. Further, such expenses cannot be deducted as Section 183 hobby expenses because such travel expenses are typically considered personal under IRC Sec. 262, and the regulations thereunder do not provide an exception for hobby-related travel expenses.

The IRS has also overruled a taxpayer claiming losses against sweepstakes winnings since they did not meet the definition of wagering. A transaction must include the following three items to be considered gambling (a wager): prize, chance and consideration. In winning the sweepstakes, the taxpayer rendered no consideration for the chance of winning the prize, therefore he had not made a wager. Incidental expenses such as postage were not sufficient to merit consideration. Thus, the taxpayer could not deduct gambling losses against the sweepstakes winnings.

Documenting Gambling Losses

Adequate documentation is required to claim gambling losses. In Rev. Proc. 77-29, the IRS stated that gamblers claiming losses must keep an accurate diary or similar record that contains at least the following information:

- The date and type of specific wager or wagering activity.
- The name and address or location of the gambling establishment.
- The names of other persons (if any) present with the taxpayer at the gambling establishment.
- The amount won or lost.

Rev. Proc. 77-29 also provides examples of support for certain types of gambling. For example, wagering on table games (twenty-one, poker, roulette, etc.) may be substantiated by the number of the table played and casino credit card data indicating where credit was issued. For lotteries, a record of ticket purchases, dates, winnings and losses, as well as supplemental records such as unredeemed tickets, payment slips, and winning statements help document the activity. Further examples for keno, slot machines, racing, and bingo are also presented in Rev. Proc. 77-29.

Generally, the courts have been somewhat less restrictive in documentation for gambling losses. If sufficient evidence exists that a taxpayer incurred a gambling loss, the courts have allowed deductions where the taxpayer can estimate a loss despite lack of substantiation. In many cases, however, the courts have disallowed all of a taxpayer's gambling losses for lack of documentation or support. The Tax Court has stipulated that the taxpayer must have evidence to corroborate the assertion that race tickets represent losses sustained by him. A race ticket alone is not adequate substantiation *(Coloney; Scoccimarro)*.

Chapter 13 Exercises

Question 1: Other itemized deductions.

Part 1: Vanessa is a consultant for a large firm. In 2011, she incurred $9,500 in travel expenses of which $8,300 was reimbursed by her employer. She has no other itemized deductions. Her AGI in 2011 was $70,000. Should she file a Form 2106 to claim unreimbursed employee expenses?

Part 2: Assume Vanessa paid $300 to have her 2010 tax return prepared. Would that change your answer?

Question 2: Job search expenses.

Phil and Frank are father and son. Phil has been working in construction for 25 years. He was recently laid off from his job as a foreman and is searching for a new position. Frank recently graduated high school and decided to enter the construction business in an entry-level position. Phil spends $3,000 on travel costs and resumes, but is unable to locate a foreman's position. Frank spends $500 on travel costs and locates an entry-level position. Are Phil's job search expenses deductible? Why or why not? Are Frank's job search expenses deductible? Why or why not?

Question 3: Education expenses.

Bill is an English teacher. He takes a year leave of absence to obtain his masters degree in school administration. Upon completion of his masters program, he plans to return to his school as a vice principal. Bill is not required by either the law or his employer to take the courses. Can Bill deduct his education expenses? Why or why not?

Question 4: Gambling losses.

Steve goes to Las Vegas several times a year to gamble. He is not a professional gambler. In 2011, he won $15,000 playing cards, but lost $23,000. How much of the winnings and losses are reportable by Steve and where are they shown on Form 1040?

Variation: Assume that Steve gambles for his livelihood and is treated as being in the trade or business of gambling. How much of the winnings and losses are reportable by Steve and where are they shown on Form 1040?

Question 5: Computing amount of deductible casualty loss.

Jim purchased a used car for $10,000 from an unrelated seller in September 2011. Because of his poor driving record, he could not obtain collision insurance. In October 2011, Jim totaled the car. He received $500 for parts and otherwise suffered a complete loss. His AGI for 2011 was $35,000. What is Jim's deductible loss?

Variation: Assume now that Jim had insurance coverage on the car but decided not to file a claim (e.g., because his coverage would be terminated). Had he filed a claim, he would have received an insurance reimbursement of $8,500, as well as the $500 salvage amount. What is Jim's deductible casualty loss under these conditions?

Chapter 13 Exercise Solutions

Question 1: Other itemized deductions.

Part 1: Vanessa is a consultant for a large firm. In 2011, she incurred $9,500 in travel expenses of which $8,300 was reimbursed by her employer. She has no other itemized deductions. Her AGI in 2011 was $70,000. Should she file a Form 2106 to claim unreimbursed employee expenses.

Answer: *No. Vanessa's net unreimbursed expenses are $1,200 which does not exceed 2% of her AGI – $1,400. Since she has employer reimbursements, she is not eligible to file Form 2106-EZ.*

Part 2: Assume Vanessa paid $300 to have her 2010 tax return prepared. Would that change your answer?

Answer: *Yes. Add Vanessa's tax prep fees of $300 (assumed to be paid in 2011 on a cash basis) to her net unreimbursed expenses of $1,200, subtract 2% of her AGI—$1,400 = $100 net deduction.*

Question 2: Job search expenses.

Phil and Frank are father and son. Phil has been working in construction for 25 years. He was recently laid off from his job as a foreman and is searching for a new position. Frank recently graduated high school and decided to enter the construction business in an entry-level position. Phil spends $3,000 on travel costs and resumes, but is unable to locate a foreman's position. Frank spends $500 on travel costs and locates an entry-level position. Are Phil's job search expenses deductible? Why or why not? Are Frank's job search expenses deductible? Why or why not?

Answer: *Phil's job search expenses are deductible, even though he was unable to locate a position, since the expenses are for the same trade or business. Frank's job search expenses are nondeductible, even though he was successful in finding employment, since this is first-time employment and, as such, must be in a new trade or business.*

Question 3: Education expenses.

Bill is an English teacher. He takes a year leave of absence to obtain his masters degree in school administration. Upon completion of his masters program, he plans to return to his school as a vice principal. Bill is not required by either the law or his employer to take the courses. Can Bill deduct his education expenses? Why or why not?

Answer: *Bill's educational expenses are deductible as work-related expenses because they meet the requirement of maintaining or improving his skills for his job and it is generally required for teachers to obtain a master's degree to maintain current employment. Also, he will be returning to work in education rather than starting a career in a new trade or business. All teaching and related duties are considered the same general kind of work.*

Note that a change of a teacher's duties in any of the following ways is not considered a change to a new business [Reg. 1.162-5(b)(3)(i)]:

- *Elementary school teacher to secondary school teacher.*
- *Teacher of one subject, such as math, to teacher of another subject, such as science.*
- *Classroom teacher to guidance counselor.*
- *Classroom teacher to principal.*

Question 4: Gambling losses.

Steve goes to Las Vegas several times a year to gamble. He is not a professional gambler. In 2011, he won $15,000 playing cards, but lost $23,000. How much of the winnings and losses are reportable by Steve and where are they shown on Form 1040?

Answer: *The $15,000 of gambling winnings is reported on line 21 (Other income) of Form 1040. Steve's deduction for gambling losses is limited to his winnings, so he claims a $15,000 miscellaneous itemized deduction on Schedule A. The $15,000 loss is not subject to the 2% of AGI floor. The remaining $8,000 of gambling losses are not deductible.*

Variation: Assume that Steve gambles for his livelihood and is treated as being in the trade or business of gambling. How much of the winnings and losses are reportable by Steve and where are they shown on Form 1040?

Answer: *Steve reports winnings of $15,000 and losses of $15,000 on Schedule C. Even though he is in the trade or business of gambling, he can still only claim losses to the extent of his winnings.*

Question 5: Computing amount of deductible casualty loss.

Jim purchased a used car for $10,000 from an unrelated seller in September 2011. Because of his poor driving record, he could not obtain collision insurance. In October 2011, Jim totaled the car. He received $500 for parts and otherwise suffered a complete loss. His AGI for 2011 was $35,000. What is Jim's deductible loss?

Answer: *Jim's deductible loss of $5,900, calculated as follows:*

Cost	*$10,000*
Insurance	*-0-*
FMV after casualty	*(500)*
Statutory reduction	*(500)*
10% of AGI	*(3,500)*
Deductible casualty loss	*$5,500*

For his 1040, the loss is computed on Form 4684 (Casualties and Thefts) and deducted on Schedule A.

Variation: Assume now that Jim had insurance coverage on the car but decided not to file a claim (e.g., because his coverage would be terminated). Had he filed a claim, he would have received an insurance reimbursement of $8,500, as well as the $500 salvage amount. What is Jim's deductible casualty loss under these conditions?

Answer: *Jim's deductible casualty loss would be zero. He would have to reduce the casualty loss deduction by any insurance coverage he would have been entitled to had he filed a claim. After reducing the cost of the car by the insurance and the FMV after the casualty, he would have a loss of $500 ($10,000 – $9,000 – $500). Thus, he would have no deductible casualty loss after considering the 10% of AGI and $500 limits.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

45. The taxpayer suffered an $8,500 casualty loss in 2011 when his apartment was robbed and he had not purchased renter's insurance. His AGI for 2011 was $35,000. How much of the loss may he include in his itemized deductions?

    a. None, as he could have been insured therefore it is not a casualty.

    b. None, because his loss is not large enough to qualify.

    c. $5,000.

    d. $4,900.

46. Which of the following may be deductible as a miscellaneous deduction for job-related expenses?

    a. Unreimbursed travel to regular work location.

    b. Reimbursed expenses for travel to a work-related convention.

    c. Expenses incurred in seeking employment in the same trade of business.

    d. Education expenses to complete a college degree not required to maintain skills.

47. When are gambling losses allowed as a deduction?

    a. The taxpayer has gambling winnings and the losses exceed deductions subject to the 2% of AGI floor.

    b. The taxpayer has gambling winnings but the losses are limited to the amount of the winnings.

    c. Gambling losses are netted against winnings and may only offset the reported winnings.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

45. The taxpayer suffered an $8,500 casualty loss in 2011 when his apartment was robbed and he had not purchased renter's insurance. His AGI for 2011 was $35,000. How much of the loss may he include in his itemized deductions? **(Page 223)**

    a. None as he could have been insured therefore it is not a casualty. [This answer is incorrect. Failure to file insurance claims can result in the loss of the deduction but not failure to purchase insurance.]

    b. None, because his loss is not large enough to qualify. [This answer is incorrect. The amount of the loss is greater than required limits.]

    c. $5,000. [This answer is incorrect. Each casualty must be reduced by a $100 floor.]

    d. $4,900. [This answer is correct. Casualty losses are first reduced by a $100 floor per event and total casualty losses are reduced by the 10% of AGI floor.]

46. Which of the following may be deductible as a miscellaneous deduction for job-related expenses? **(Page 226)**

    a. Unreimbursed travel to regular work location. [This answer is incorrect. Only travel to temporary job locations is deductible.]

    b. Reimbursed expenses for travel to a work-related convention. [This answer is incorrect. Only unreimbursed expenses are deductible by employees.]

    c. Expenses incurred in seeking employment in the same trade of business. [This answer is correct. Expenses to seek a new job in the same trade or business are deductible. If a new trade or business, the expenses are not deductible.]

    d. Education expenses to complete a college degree not required to maintain skills. [This answer is incorrect. Completion of a degree which is not required of the employer nor maintains or improves current skills is nondeductible.]

47. When are gambling losses allowed as a deduction? **(Page 231)**

    a. The taxpayer has gambling winnings and the losses exceed deductions subject to the 2% of AGI floor. [This answer is incorrect. Gambling losses are not included in deductions subject to the 2% of AGI floor.]

    b. The taxpayer has gambling winnings but the losses are limited to the amount of the winnings. [This answer is correct. Per IRC Sec. 165(d), taxpayers can deduct gambling losses only to the extent of gambling winnings.]

    c. Gambling losses are netted against winnings and may only offset the reported winnings. [This answer is incorrect. Only gambling professionals may net losses against winnings.]

EXAMINATION FOR CPE CREDIT

Chapter 13

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

43. An itemized deduction which is subject to both a $100 floor and a 10% of AGI floor is a:

    a. Job related expense.

    b. Medical expense.

    c. Casualty loss.

    d. Gambling loss.

44. Employees may deduct expenses incurred for:

    a. Education to enter a new trade or business.

    b. Most job-related expenses if they do not exceed 2% of AGI.

    c. Any reimbursed job-related expenses.

    d. Unreimbursed use of their personal vehicle to make sales calls.

45. Professional gamblers differ from nonprofessional gamblers in which way?

    a. Professional gamblers losses are not limited.

    b. Nonprofessional gamblers are required to net winnings and losses.

    c. Professional gamblers report their winnings and losses on Schedule C as a trade or business.

    d. They do not differ in their tax treatment of gambling activity.

Chapter 14: Personal Credits

Learning Objective

Completion of this chapter will enable you to:

- Determine eligibility and deductibility of various personal credits available to individuals.

Introduction

Several refundable and nonrefundable personal tax credits are available to individuals. Some of these, such as the credit for child and dependent care, are available without regard to the taxpayer's income. Others, such as the earned income credit, the adoption expense credit, the child tax credit, and the education credits are subject to phase-out for taxpayers whose income exceeds certain prescribed thresholds.

Taxpayers can use all nonrefundable personal tax credits (i.e., the credit for child and dependent care expenses, the elderly or the disabled, adoption expenses, qualifying children, interest on certain home mortgages, education expenses, qualified retirement savings contributions, and residential energy efficient property) against both regular tax and AMT for 2010. Most of these credits have been extended through 2011 under the Tax Relief Act of 2010 for AMT purposes.

The Internal Revenue Service has issued a ruling applying a uniform method of determining when a child attains a specific age for purposes of Section 21 (dependent care credit), Section 23 (adoption credit), Section 24 (child tax credit), Section 32 (earned income credit), Section 129 (exclusion for dependent care assistance), Section 131 (exclusion for foster care payments), Section 137 (exclusion for adoption assistance), and Section 151 (dependency exemption). Rev. Rul. 2003-72 provides that for these previously mentioned provisions, a child is considered to attain a given age on the anniversary of the date that the child was born. For example, a child born on January 1, 1993, attains the age of 17 on January 1, 2011.

Under the child tax credit provisions, a qualifying taxpayer could take the child tax credit in 2011 for a child born on January 1, 1995, because the child is not considered to attain age 17 until 2012 (for the child tax credit, the child must *not* have attained the age of 17 during the tax year).

Summary of Credits

This is a table of the most common **personal tax credits**:

IRC Sec.	Ref.	Credit Title	Form Number	IRS Pub.	Refundable
32	3	Earned Income Credit	EIC	596	Yes
27	4	Foreign Tax Credit	1116	514	No
23(a)	5	Adoption Credit	8839	968	No
21, 45(f)	6	Child and Dependent Care Credit	2441	503	No
42	7	Mortgage Interest Credit	8396	530	No
22	8	Credit for Elderly	Schedule R	524	No

IRC Sec.	Ref.	Credit Title	Form Number	IRS Pub.	Refundable
24(d)	9	Child Tax Credit, additional child tax credit	1040, 8812	972	Depends
25(b)	10	Low Income Saver's Credit	8880	590	No
36	11	Credit for First-Time Homebuyers		—	No
25a		Education: American Opportunity Tax Credit (aka Hope Credit)	8863	970	Up to 40%
25a		Education: Lifetime Learning Credit	8863	970	Yes
36A		Government Retirees	n/a	n/a	Yes
36A		Making Work Pay Credit	Sch M	n/a	Yes

Earned Income Credit

The earned income credit (EIC) is intended to provide targeted tax relief to low-income to moderate-income taxpayers. This refundable personal credit is available to certain taxpayers based on their earned income, adjusted gross income, and number of qualifying children. It is one of the most error-prone areas on individual income tax returns due to complexity in applying the law. The GAO has placed the EIC on its list of high-risk programs.

For several years, the IRS has been checking EIC claims with a correspondence audit-like program. Preparers can be held responsible for failure to adhere to due diligence in screening whether an individual is qualified for the credit or not.

There are two classes of taxpayers eligible for the EIC: taxpayers without a qualifying child and taxpayers with at least one qualifying child.

Taxpayers without a qualifying child must meet three tests to claim EIC:

1. The taxpayer's principal place of abode is within the U.S. for more than one-half of the tax year,
2. The taxpayer (or if married, either the taxpayer or the spouse) must be between 25 and 64 years of age at the end of the year, and
3. The taxpayer(s) are not being claimed as a dependent by another taxpayer for that tax year.

Children must meet the definition of a "qualifying child" under the uniform-definition-of-a child rules.

Certain taxpayers will be excluded from the definition of "eligible individual" despite meeting the above tests. These are:

1. Any individual who is the qualifying child of another taxpayer for any given tax year may not claim the EIC on their own tax return; and
2. Certain nonresident aliens and individuals living abroad who do not choose to have worldwide income subject to U.S. income tax.

The tie-breaking rules discussed in the Uniform Definition of a Child apply for EIC purposes. There is significant confusion as to how these rules are applied in practice. The following examples were taken from IRS Pub. 17, "Your Income Tax."

Court Case: Divorced father was not entitled to EIC for his two children. The divorce decree provided that the mother was the custodial parent and neither child lived in father's home for more than half of the year (*Godby*).

Example: Sue and her 2-year-old son, Derick, lived with Joan, Sue's mother all year. Sue is 25 years old. Her only income was $9,000 from a part-time job. Joan's only income was $20,000 from her job. Derick is a qualifying child for both Sue and Joan. However, only one of them can use Derick to claim the EIC. Sue and Joan may choose which of them will treat the child as a qualifying child to claim the EIC. However, if there is a disagreement, Sue, as the child's parent, will be the only one allowed to claim the credit using this child.

Variation: The facts are the same, except that Sue also has two other young children who lived with her and her mother and are qualifying children of both. Only one of them (Sue or Joan) can use each child to claim the EIC. However, Sue and Joan may split the three qualifying children between them. For example, Sue can use Derick and Joan can use the other two children, allowing both taxpayers to claim EIC.

Example: Fred, Lucy, and Annie (who is 10 years old) lived together until July 1, when Fred moved out of the household. In July and August, Annie lived with Fred. In September and October, she lived with Lucy. On November 1, Fred and Lucy were divorced. For the rest of the year, Annie lived with Fred, who was given custody. In these circumstances, Annie is a qualifying child for both Fred and Lucy. Fred and Lucy may choose which of them will treat the child as a qualifying child to claim the EIC. However, if they are unable to agree and both use the child to claim the EIC, only Fred will be allowed to claim the credit because Annie lived with him longer than with Lucy. Lucy is also not allowed to claim EIC for persons without a qualifying child.

Example: Peggy, Jimmy (her 5-year-old son), and Hank (her son's father) lived together all year. Peggy and Hank are not married. Jimmy is a qualifying child for both Peggy and Hank. Peggy earns $8,000 and Hank earns $18,000. Peggy and Hank may choose which of them will treat Jimmy as a qualifying child in order to claim the EIC. However, if both use the child to claim the EIC, only Hank will be allowed to claim the credit using this child because his AGI ($18,000) was higher. Peggy cannot claim the EIC for persons either with or without a qualifying child.

Example: Sara and Abby, her 7-year-old niece, live with Lois, Sara's mother, all year. Sara cares for Abby as she would her own child. Sara is 25 years old and her only income is $9,300 from a part-time job. Lois' only income was $15,000 from her job. The result is that Abby is a qualifying child of both Sara and Lois. Because only one of them may treat Abby as a qualifying child to claim the EIC, Sara and Lois must choose. If they are unable to agree and both use the child to claim the EIC, only Lois will be allowed to claim the credit using Abby because her AGI ($15,000) is higher than Sara's AGI ($9,300).

The 2011 earned income tax credit limits are as follows:

2011 EIC Table		
# of Qualifying Children	**Earned Income/AGI < Amount (MFJ add $5,010)**	**Maximum Credit**
0	$13,660	$ 464
1	$36,052	$3,094
2	$40,964	$5,112
3 or more	$43,998	$5,751

A number of states have EITC programs that operate in addition to the federal program. This website has a list of them: **www.stateeitc.com**.

Members of the U.S. Armed Forces receive additional pay for serving in a combat zone which is known as **combat pay**. Under IRC Sec. 112, such income is excludable from taxable income. Military personnel may elect to treat excluded combat pay as earned income for EIC purposes. This provision was made permanent—amended by the 2008 Heroes Act.

The EIC is subject to a phase-out calculation determined by the taxpayer’s applicable credit percentage, the applicable “phase-out” percentage, and the larger of the taxpayer’s earned income or adjusted gross income.

Additional limitations to claiming the EIC include:

1. Individuals having excess investment income (greater than $3,150 for 2011) may not claim EIC. Disqualified income is defined by IRC Sec. 32(i)(2) as taxable interest or dividends, tax-exempt interest, net income from rents or royalties not derived in the ordinary course of a trade or business, capital gain net income, or net passive income.

   There is no phase-out calculation for excess investment income. A taxpayer with $3,151 of disqualified income in 2011 will receive no EIC, regardless of income or number of qualifying children.

2. Married filing separately taxpayers do **not** qualify for the EIC.

3. Taxpayers who it has been determined have filed improper claims for EIC may be precluded from filing a current (or future) year claim for the credit.

Tax preparers may be subject to a $100 penalty for each failure to comply with the due diligence requirements under Reg. 1.6695-2(d) in determining a taxpayer’s eligibility for the EIC. Keep a copy of form 8867, Preparers EIC checklist, and a computation of the credit in your files for three years after the June 30 following the date the return was presented to the taxpayer for signature.

Foreign Tax Credit

U.S. citizens are subject to tax on their worldwide income. To avoid double taxation, a foreign tax credit is allowed under IRC Sec. 27 when income is subject to both foreign and U.S. tax. This calculation must be distinguished from the foreign income exclusion for citizens.

Taxpayers are allowed to treat the amount of foreign taxes paid as either a deduction from income (Form 1040, Schedule A) or as a nonrefundable tax credit. The credit will generally be preferable as it provides dollar-for-dollar tax savings. The deduction will generate tax savings only at the taxpayer's marginal tax rate.

Computing the Foreign Tax Credit (FTC)

The credit equals the lesser of the amount of foreign tax actually paid, or the amount of U.S. tax that would be due on the foreign income.

Foreign taxes eligible for the credit include those levied on income or profits, including wages, interest and dividends, and royalties.

The FTC is allowed against both regular tax and AMT, but must be recomputed for AMT purposes using the AMT income and tax amounts.

Disallowed foreign tax credits can be carried back one year and carried forward ten years. This does not apply if they claim the credit using the simplified method discussed in the next paragraph.

Generally taxpayers must file Form 1116 to claim the FTC. However, many taxpayers may claim the credit without filing Form 1116. To qualify for the simplified method, taxpayers must meet all of the following requirements:

1. All of the foreign gross income is from the "passive income" category, including interest and dividends;

2. All of the foreign gross income and taxes paid were reported on a qualified payee statement, such as a Form 1099-DIV, 1099-INT, or Schedule K-1; and

3. The total creditable foreign taxes do not exceed $300 ($600 if married filing a joint return).

Taxpayers are denied any double benefits from combining the foreign tax credit (or deduction) with the foreign earned income exclusion. A taxpayer cannot take a foreign tax credit or a deduction for any taxes attributable to income that has been excluded under the foreign earned income exclusion or the foreign housing amount exclusion. Income subject to foreign taxation in excess of the applicable amounts in IRC Sec. 911, however, is eligible for a deduction or credit.

U.S. citizens, resident aliens and nonresident aliens who paid foreign income tax and are subject to U.S. income tax on foreign source income qualify to take the credit.

There are four tests that must be met for any foreign tax to qualify for the credit:

1. The tax must be imposed on you;
2. You must have paid or accrued the tax;
3. The tax must be legal and actual foreign tax liability; and
4. The tax must be an income tax or a tax imposed in lieu of an income tax.

There are two limitation tests that must be attained in order to determine the proper foreign tax credit.

1. The first limitation test requires the taxpayer to separate foreign income by category. The taxpayer must figure the credit limitation on a separate Form 1116 for each of the following types of income.
2. The second test provides an overall limitation on the amount of foreign tax credit that may be taken.
   a. The total amount may not exceed the same proportion of the tax against which the credit is taken (i.e., the U.S. tax) that the taxpayer's taxable income from sources without the United States bears to his/her entire taxable income.

Example: Mary Melody owns shares of a mutual fund holding foreign investments. In 2010, Mary receives $10,000 in dividend income from the foreign investments and $1,500 in foreign tax is withheld. Mary's other domestic income totals $490,000 and her total U.S. tax is $50,000. The credit is limited to $1,000, the lesser of $1,500 foreign tax withheld or the amount of U.S. tax that would be due on the foreign income ($10,000 divided by $500,000 ($10,000 + $490,000) times $50,000 or $1,000).

The American Jobs Creation Act of 2004 gave taxpayers an election to take advantage of a liberalized rule for allocating interest expense between U.S. sources and foreign sources for purposes of determining a taxpayer's foreign tax credit limitation. The "American Housing Rescue and Foreclosure Prevention Act of 2008," delays the phase-in of this new rule to tax years beginning after 2010.

Adoption Credit and Income Exclusion

There are two types of tax incentives for those who adopt, or in some cases attempt to adopt, a child. There is a tax credit available for all qualifying taxpayers. There is an exclusion available for qualifying taxpayers whose employers pay for adoption costs.

Adoption Credit and Income Exclusion

The 2011 maximum credit increased to $13,170. The modified adjusted gross income phase-out threshold increased to $182,520, and is completely phased out at $222,520.

The $13,360 credit for a special-needs adoption is allowed in the year the adoption is final, regardless of whether the taxpayer has qualified adoption expenses.

The credit for adoption expenses is a refundable personal credit in 2010 and 2011. It is available to qualified taxpayers for eligible expenses incurred in a qualified adoption. The general provisions for the credit for adoption expenses include:

1. Taxpayers may claim a credit of up to $13,360 regardless of the child's need.
2. Benefit dollar limitations are based on the adoption of each child and are cumulative over all taxable years (not an annual limitation). This includes any amounts paid for qualified adoption expenses in connection with any unsuccessful attempts to adopt an eligible child before the successful final adoption of another child.
3. The adoption must be of an eligible child. An eligible child is any child:
   a. Under the age of 18 at the time of the adoption; or
   b. Physically or mentally incapable of caring for themselves.
4. An eligible special-needs child must meet two additional criteria:
   a. The State has determined the child cannot or should not be returned to his/her parents, and because of certain circumstances such as ethnic background, age, physical, mental, or emotional handicaps, cannot be placed with adoptive parents without providing adoption assistance, and
   b. The child is a citizen or resident of the United States.
5. A taxpayer must incur qualified adoption expenses, which include:
   a. Reasonable and necessary adoption fees, court costs, attorney and accountant fees, travel expenses (including meals and lodging), and other expenses directly related to the legal adoption of an eligible child; and
   b. Costs of construction, renovations, alterations or purchases specifically required by the State to meet the needs of the child. To the extent that these expenses result in a credit, the basis of the property must be reduced.
6. Qualified adoption expenses do **not** include the following:
   a. Expenses incurred in the violation of State or federal law.
   b. Expenses incurred in a surrogate parenting arrangement or in the adoption of a spouse's child.
   c. Expenses reimbursed under an employer program or otherwise.
   d. Expenses allowed as a credit or deduction under any other provision of the federal income tax law.
7. The credit benefit will be reduced when the taxpayer's modified adjusted gross income (as defined under IRC Sec. 23(b)(2)(B)) is $182,180 or more, phasing out completely at $222,180.
8. The credit may offset the sum of regular tax liability and alternative minimum tax. Certain nonrefundable personal credits (e.g., dependent care credit) must be exhausted before the adoption credit is allowable.

Any credit for adoption expenses disallowed may be carried forward for the next five tax years and is used on a FIFO (first in, first out) basis.

9. Tax compliance rules include:

   a. Married couples must file a joint return to claim the credit for adoption expenses.

   b. A taxpayer is not considered married and may file a separate return if:

      1) Legally separated under a decree of divorce or separate maintenance; or

      2) Lived apart from the spouse for the last six months of the years, and lived with, and maintained a home for, an eligible child for more than half the year.

   c. The taxpayer must include the name, age, and social security number of the eligible child on the tax return that claims the adoption benefits.

   An adoption TIN (taxpayer identification number) or ATIN, may be obtained from the IRS by filing Form W-7A in the event that the adoptive parents are unable to obtain a SSN for the eligible child prior to the tax return due date. The ATIN will remain in effect for up to two years, and will allow the taxpayer to qualify for the credit for adoption expenses, dependent care credit, child credit, and the dependency exemption.

10. The timing of the credit for adoption expenses is somewhat unusual, and is dependent on the status of the eligible child being adopted.

    For an eligible child who is a U.S. citizen or resident at the time the adoption commences (i.e., a domestic adoption), the credit is allowed in the tax year following the year the expenses are paid, unless the expenses are paid in or after the tax year the adoption becomes final. If qualified adoption expenses are paid in or after the tax year the adoption is final, the credit is allowed in the tax year the expenses are paid.

    For an eligible foreign-born child who is not a U.S. citizen or resident, the credit is only available in the year the adoption becomes final. Adoption expenses paid in any year prior to the year the adoption is final are carried over until the adoption becomes final. If the adoption is never finalized, no credit is allowed.

11. There has been confusion and ambiguity surrounding adoptions of foreign-born children. Specifically, the determination when the adoption is final and what are reasonable adoption expenses have been particularly troublesome for taxpayers. Rev. Proc. 2005-31 clarifies both of these concerns.

    Reasonable foreign adoption expenses include “any reasonable and necessary expenses” such as court costs, adoption fees, attorney fees, travel expenses (including meals and lodging) and other expenses directly related to, or for the principal purpose of, the legal adoption of an eligible child by the taxpayer. The adoption is final (and the credit may be taken) in the year:

    a. A competent authority of a foreign country has entered a decree of adoption.

    b. The child receives an IR visa (IR2, IR3 or IR4), from the U.S. Dept. of State.

Adoption Assistance Programs (IRC Sec. 137)

In addition to the credit described above, there is an income exclusion available to certain taxpayers whose employers provide adoption assistance programs. Under these programs:

1. Qualified employees may exclude up to $13,360 of adoption expenses paid by an employer under an adoption assistance program;
2. The amount excludable is subject to the same phase-out provisions based on modified adjusted gross income as the credit for adoption expenses;
3. The employer should maintain a separate written plan (funded or unfunded); and
4. The plan may not discriminate in favor of highly compensated employees.

Any taxpayer who receives employer-provided adoption benefits in 2011 in connection with the adoption of a foreign child, which is not finalized, must include the benefits in wages (Form 1040).

An individual may claim both a credit and exclusion in connection with the adoption of an eligible child. However, a taxpayer may not claim both a credit and exclusion for the same expenses.

Child and Dependent Care Credits and Exclusion

The tax credit and income exclusion are available to help offset the expenses incurred for the care of a child, spouse, or other dependent while the taxpayer is gainfully employed, looking for work, or attending school full-time.

Internal Legal Memorandum 200812024 (ILM) concludes that, apart from a dependency exemption, a taxpayer's qualifying relative may not qualify him for earned income credit, household filing status, or the child tax credit, but in limited circumstances may qualify the taxpayer for the child and dependent care credit.

Household and Dependent Care Credit

This nonrefundable personal credit is available to certain taxpayers for expenses incurred for the care of a child, spouse, or other dependents while working. To claim the credit, a taxpayer must:

1. Have a qualifying individual, which includes:
    a. A "qualifying child" (under the Uniform Definition of a Child rules) who is under age 13 at the end of the year;
    b. A dependent of the taxpayer who is incapable of self-care;
    c. The spouse of the taxpayer, if the spouse is physically or mentally incapable of self-care;
    d. A taxpayer who may claim an individual as his or her qualifying relative may not claim the dependent care credit, unless that qualifying relative is physically or mentally disabled.

2. Incur household and dependent care expenses to allow the taxpayer (and spouse) to work, attend school full-time, or look for work;
3. Have earned income or be a full-time student during the year;
4. Make payments for household and dependent care expenses to a dependent care center or to an individual:
   a. Whom the taxpayer (or spouse) cannot claim as a dependent; and,
   b. Who is not the taxpayer's child under age 19 at the end of the year.
5. Identify the care provider on his/her income tax return, including social security number or employer identification number;
6. File a joint return if married, or Head of Household if qualified; and
7. File Form 1040 or 1040A, but not Form 1040EZ.

Computing the Credit

The credit is computed by multiplying the maximum allowable credit percentage by the employment-related expenses (household and dependent care expenses) paid by the taxpayer.

1. The applicable percentage ranges between 20% and 35%, based on AGI.
2. The maximum eligible employment-related expense is $3,000 for one qualifying individual and $6,000 for two or more.

Dependent Care Assistance Program

An exclusion is available to certain taxpayers whose employers provide dependent care assistance programs:

1. Employees may exclude up to $5,000 of dependent-care assistance costs annually. Married filing separate employees may exclude up to $2,500.
2. The excluded amounts are not subject to FICA or FUTA.
3. The amount excluded from income cannot exceed:
   a. Earned income of an unmarried employee, or
   b. For a married employee, the lesser of (1) the employee's earned income; or (2) the spouse's earned income.
4. A nonworking spouse who cannot physically or mentally care for him/herself, or a spouse who is a full-time student for at least five months of the year are deemed to have earned $250 per month for one qualifying person, or $500 per month for two or more qualifying persons.
5. The exclusion is not allowed for payments to individuals who qualify as dependents of the employee or their spouse; or the taxpayer's child, if under age 19 at the end of the year.

Mortgage Interest Credit

The Mortgage Interest Credit is intended to help lower income individuals afford home ownership. It may only be claimed on a taxpayer's return if that taxpayer received a qualified Mortgage Credit Certificate (MCC). This certificate must be issued by a state or local governmental unit or agency under a qualified mortgage credit certificate program.

The credit is claimed on Form 8396 using the credit percentage given on the mortgage credit certificate. There is a three year carryover of any unused amounts.

If the mortgage loan amount is greater than the certified indebtedness amount on the certificate, the credit is only allowed on a part of the interest. The percentage calculated below is multiplied times the interest paid in the current year to derive the credit:

$$\frac{\text{Certified Indebtedness on MCC}}{\text{Original amount of mortgage}} \times \text{Interest Expense} = \text{Credit amount}$$

If the credit rate exceeds 20%, the maximum amount of the credit is $2,000.

If the homeowner sells or otherwise disposes of the residence within nine years after the loan was provided, the credit is subject to recapture (Form 8828).

Credit for the Elderly and/or Permanently Disabled

This credit is equal to 15% of eligible income and is available to individuals who are 65 years of age or older; or under 65 but who are retired due to permanent and total disability and had taxable disability income.

The base amount used to figure the credit is:

1. $5,000 for a single person, widow, or widower or if married filing jointly and only one spouse is a qualified individual;
2. $7,500 if married filing jointly and both are qualified individuals;
3. $3,750 for a qualified individual who is married, filing separately;
4. If a qualified individual is under age 65 and has disability income of less than $5,000, the base amount is limited to $5,000.

There is an overall AGI limitation. It is reduced by 50% of the amount exceeding the AGI at the beginning of the phase-out level below. Income eligible for the credit is reduced by:

1. Any social security payments and other excludible pensions or annuities received by the taxpayer, and
2. Half of the taxpayer's adjusted gross income that exceeds the following levels:
   - Single taxpayers $ 7,500
   - Married persons filing jointly $ 10,000
   - Married persons filing separately $ 5,000

A taxpayer age 65 or older starts with a Tax Credit for the Elderly based on a specified amount that is reduced by (i) any social security payments and other excludible pensions and (ii) by one-half (50%) of any adjusted gross income over the stated maximum. The results, if any, are multiplied by 15% to arrive at the allowable tax credit. The credit is claimed on Schedule R.

Child Tax Credit

The Working Family Tax Relief Act of 2004 (WFTRA) increased the child tax credit from $600 to $1,000 per qualifying child through 2010, and the Tax Relief Act of 2010 extended the $1,000 per qualifying child through 2012, after which it reverts to the 2000 level of $500 per qualifying child.

If a taxpayer isn't able to take full advantage of the regular calculation because the tax liability was too low, an additional calculation may result in part of the credit being refundable.

The Child Tax Credit is available to certain taxpayers with qualifying children. General provisions of the credit include:

1. A taxpayer must have at least one qualifying child, as defined under the Uniform Definition of a Child rules discussed elsewhere in the course. In addition, a qualifying child must:

   a. Be claimed as a dependent of the taxpayer; and

   b. Not have reached age 17 as of the close of the calendar year for which the child credit is claimed.

   The noncustodial parent can claim the dependency exemption with Form 8332. The child tax credit follows the exemption and the noncustodial parent may claim the credit.

2. The credit will be reduced if the taxpayer's modified adjusted gross income (as defined under IRC Sec. 24(b)(1)) is above certain thresholds. The credit is reduced by $50 for each $1,000 of modified adjusted gross income (or fraction thereof) above the threshold. These thresholds are not indexed for inflation. The end of the phase-out depends on the number of qualifying children.

Filing Status	Threshold
Married Filing Jointly	$ 110,000
Single or Head of Household	75,000
Married Filing Separately	55,000

3. All nonrefundable credits available to a taxpayer must be claimed prior to calculating the refundable portion of the child credit.

Refundable and Nonrefundable Provisions

There are two formulas for determining any refundable portion:

1. For taxpayers with one or two qualifying children, the child tax credit is refundable to the extent of 15% of the taxpayer's earned income in excess of $8,500.

2. For taxpayers with three or more qualifying children, the refundable portion of the child tax credit is the amount by which:

   a. The taxpayer's social security taxes exceed the taxpayer's earned income credit; if

   b. That amount is greater than the refundable credit based on the taxpayer's earned income in excess of $8,500 (amended by the 2008 Extenders Act).

3. The total amount of the allowable refundable child tax credit may never exceed the amount that would result from its calculation as a nonrefundable credit.

IRC Sec. 24(d)(1), as amended, provides combat pay that is otherwise excluded from gross income may be treated as earned income for purposes of calculating the refundable portion of the Child Tax Credit.

Credit for Retirement Savings Contributions

The Credit for Retirement Savings Contributions is a nonrefundable personal credit for $1,000 ($2,000 for MFJ) based on an eligible individual's qualified retirement savings contributions.

To claim the credit, a taxpayer must meet certain eligibility requirements:

1. An eligible individual:

   a. Must be at least 18 years old at the end of the taxable year and not be eligible to be claimed as a dependent by another taxpayer;

   b. Must not be a full-time student during five or more months of the calendar year; and

   c. Must have adjusted gross income at (or below) certain thresholds:

Married filing joint	$55,500
Head of household	$41,625
Single (or married filing separately)	$27,750

MFS does not qualify.

Qualified retirement savings contributions include contributions to any qualified plan or any type of IRA.

The amount of the credit equals the qualified retirement savings contributions times the applicable credit percentage (10% - 50%) based on the taxpayer's modified adjusted gross income. The maximum credit is $1,000 (maximum qualified retirement savings contributions of $2,000 times the maximum percentage of 50%).

Credits for First-time Homebuyers

The Housing Assistance Act of 2008 introduced a credit allowed for the tax year in which a qualifying residence is purchased. (This credit replaced a similar credit which only applied to the purchase of a principal residence in the District of Columbia.)

Since then, the American Recovery and Reinvestment Act of 2009 extended and modified the first-time homebuyer credit.

1. For qualifying home purchases between April 9, 2008, and November 30, 2009, eligible first-time homebuyers get a refundable tax credit equal to the lesser of 10% of the purchase price of a principal residence or $8,000 ($4,000 for married individuals filing separately).

2. If a home is purchased in 2009 (and before the November 30, 2009 deadline) the taxpayer can elect to treat the purchase as though it were made on December 31, 2008, and take the credit on their 2008 return.

3. The credit phases out for individual taxpayers with modified adjusted gross income between $75,000 and $95,000 ($150,000–$170,000 for joint filers) for the year of purchase.

4. A credit claimed for a home purchased between April 9, 2008, and December 31, 2008, is automatically recaptured ratably over 15 years, with no interest charge, beginning in the second year after the year the home is purchased. The recapture is computed as additional income tax, computed each year at 6⅔ % of the credit. (This rule does not apply for homes purchased in 2009 that a taxpayer elects to treat as purchased on December 31, 2008.) **WARNING** – For clients that benefited from this version of the first time home buyer credit, the recapture of the tax credit has begun. A home sold within the 15-year period accelerates the recapture provisions.

5. A credit claimed for a home purchased between January 1, 2009 and November 30, 2009 is not subject to the credit recapture unless the taxpayer disposes of the residence or the residence ceases to be the taxpayer's (or spouse's) principal residence during the 36-month period beginning on the date of purchase.

6. To be qualified as a "first-time homebuyer," a purchaser or spouse must not have owned a principal residence in the U.S. for the three-year period before the qualifying home purchase.

   A buyer could have a vacation home which was not a principal residence; if they lived in an apartment in the NYC. Their subsequent purchase of a home (including a condo or coop) would qualify them for the credit.

7. If two or more unmarried persons purchase a home together, the credit will be allocated between them using any reasonable method.

Worker, Homeownership and Business Assistance Act

The tax credit for first-time homebuyers was scheduled to expire on November 30, 2009. HR 3548 extends the credit to April 30, 2010. Additionally, Congress has expanded the definition of who qualifies as a "first-time homebuyer" to include people who currently own a house and have owned and lived in their residence for any consecutive five-year period during the eight-year period ending with the date when their new home is purchased. Such long-time homeowners who buy a new residence are eligible for a tax credit of up to $6,500 if they buy another residence between November 7, 2009, and April 30, 2010.

Energy Efficient Home Credit for Homeowners

Before 2008, homeowners were allowed a credit of 10% of the amount paid or incurred for qualified energy efficiency improvements or 100% of the cost of qualified residential energy property installed during the taxable year. This credit was allowed only for expenditures incurred after December 31, 2005, and before January 1, 2008. However, the Energy Improvement and Extension Act of 2008 extends this credit for one year with several modifications including adding biomass fuel stoves, excluding geothermal heat pumps, broadening the type of water heaters that qualify, and including certain metal and asphalt roofs.

Caution: The extension skips a year, so it was not available for 2008.

For 2009 and 2010, the American Recovery and Reinvestment Act of 2009 modified and extended the credit. A nonrefundable credit equal to 30% of the cost of personal energy property (certain energy saving improvements such as insulation, doors, windows, electric heat pumps, etc. to a principal residence) is available. The credit is limited to a total of $1,500 for 2009 and 2010. Expenditures from subsidized energy financing can be considered for the credit.

The 30% tax credit of the energy saving home improvements was extended by the Tax Relief Act of 2010 through 2011. The lifetime limit of $500 is reinstated.

Personal Residential Efficient-Energy Credit

Effective 2009 through 2016, the American Recovery and Reinvestment Act of 2009 provides a nonrefundable credit equal to 30% of the cost of residential energy efficient property (qualified solar water heating, geothermal heat pump, fuel cell, small wind energy, and solar electric property). The tax credit for 30% of the cost of installing solar water heating equipment, solar electric equipment, geothermal heat pumps or small wind turbines in a primary residence or second home is unlimited in 2010. For qualified fuel cell property, the credit is limited to $500 for each 0.5 kilowatt of capacity. Expenditures from subsidized energy financing can be considered for the credit.

The Tax Relief Act of 2010 extended this credit by 1 year through 2011.

The American Opportunity Tax Credit (formerly known as the Hope Credit)

For 2009 and 2010, the Hope education credit is renamed the American Opportunity Tax Credit (AOTC) and modified by:

- Increasing the credit limit to $2,500 per eligible student per year (100% of first $2,000 and 25% of next $2,000 of eligible expenses).
- Expanding the definition of eligible expenses to include course materials.
- Allowing the credit for the first four years of the student’s postsecondary education in a degree or certificate program.

- Increasing the modified AGI phase-out range to $80,000–$90,000 ($160,000–$180,000 for MFJ).
- Permitting the credit to be claimed against AMT.
- Allowing 40% of the credit to be refundable (but not if subject to kiddie tax).

The Tax Relief Act of 2010 extends for two years the 2009 and 2010 modifications to the Hope credit that are known as the AOTC.

An eligible student for purposes of the AOTC is one who meets the following requirements:

1. The student is an individual who is enrolled for at least one academic period in a degree, certificate, or other program leading to a recognized educational credential.
2. **Must carry at least half the normal full-time workload** (as determined by the institution) for the student's course of study. If the student meets the half-time requirement for one academic period during the year, the tuition for other periods during the year when this requirement is not met still counts as an eligible expense for Hope credit purposes.

> **Example:** Honolulu U. has a 12-hour full-time curriculum per semester. Wiekie Key needs to carry a six-hour load at least one semester during 2011 to claim the AOTC.

3. As of the beginning of the taxable year, the student has not completed the first four years of postsecondary education at an eligible educational institution. The following provisions apply:
   a. Proposed regulations provide that whether a student has completed the first two years of postsecondary education depends on whether the particular institution awards the student two years of academic credit prior to the beginning of the tax year.

> **Example:** Tex Books attends Reading University (RU) and attains junior status in philosophy. The job market for philosophy is "theoretically fatalistic" and Tex transfers in the fall of 2011 to Just the Facts College (JTFC) to "pursue the doctrine of wisdom" (i.e., an undergraduate degree in accounting) where the starting salary is now $50,000 per year. Tex is at least a half-time student for that semester. Unfortunately, Tex is able to transfer only enough RU credits to be accorded second-semester-freshman status when he enters JTFC. Assuming Tex or his parents have not claimed the AOTC twice, the 2011 tuition and fees at JTFC qualify as eligible expenses for the AOTC.

   b. Academic credit awarded solely on the basis of the student's performance on proficiency examinations is disregarded. Generally, classification as a freshman or sophomore anytime during the tax year will enable the student to meet this requirement. The student's year-of-study depends on his/her standing at the current institution. When a student has studied at another school, only credits that are successfully transferred to the new school are counted in determining the student's year of study at the new school.
      1) So "testing out" of classes will not hurt the student's eligibility for the Hope credit.
      2) Only actual class credit is counted in determining the student's year-of-study status.

c. The same concept applies to credit earned by the student while not enrolled in a degree program, such as when college courses are taken while the student is still in high school.

   1) Even if the student later enrolls in the same college and is awarded academic credit from the courses taken while in high school, they don't count in determining the student's year-of-study status for AOTC purposes.

   2) Nor are the expenses of taking such courses eligible to be claimed as an AOTC, unless (and this is an important exception) the student later in that same year becomes an eligible student.

4. The AOTC is generally not allowed for any academic period if the student has been convicted of a federal or state felony consisting of the possession or sale of illegal drugs for an offense that occurred while they were receiving federal financial aid. **FAFSA has developed a special worksheet to determine eligibility.**

> **Example:** Dan Pepper was arrested and convicted of smuggling drugs. He is potentially ineligible for an AOTC. He must check yes in FAFSA Question 31 and FAFSA will send a worksheet to determine eligibility.

A taxpayer may claim the credit for each eligible student, which includes the taxpayer, taxpayer's spouse or an individual eligible to be claimed as a dependent.

The maximum credit is $2,500 per student, per year. It is calculated as follows:

1. **100% of the first $2,000** of qualified tuition and fees; plus
2. **25% of the next $2,000** of qualified tuition and fees.
3. The maximum qualified tuition and fees needed to maximize the credit are **$4,000**.

Lifetime Learning Credit

The Lifetime Learning credit covers tuition and fees required for enrollment or attendance at an eligible educational institution for courses of instruction of such individuals at such institution to acquire or improve job skills of the individual and available for undergraduate, graduate or professional courses

A taxpayer may claim the credit once annually for the combined expenses paid by the taxpayer for all eligible students, which include the taxpayer, taxpayer's spouse, and individuals claimed as dependents.

The maximum credit is $2,000 for each eligible taxpayer per year. It is calculated as follows:

1. Qualifying tuition and fees up to **$10,000**; multiplied by a 20% credit.
2. The credit is not adjusted for inflation.

A comparison must be made between the American Opportunity Tax Credit and Lifetime Learning credit to determine which will produce the higher credit for a student. A rule of thumb is if you spend more than **$9,000,** choose the Lifetime Learning credit. Remember to consider state tax rules, too!

There are no restrictions for the number of years, a degreed program, being a half-time student, or being a convicted felon.

Common Provisions of the AOTC and Lifetime Learning Credit

An eligible educational institution for purposes of either education credit is defined by reference to Section 481 of the Higher Education Act of 1965. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions, and includes some vocational schools. The institution must offer credit toward a bachelor's degree, an associate's degree, or another recognized postsecondary education credential. The institution must be eligible to participate in Department of Education student aid programs.

The credit is allowed for an eligible student who may be the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer may claim a dependency exemption, and the taxpayer is deemed to have paid all expenses.

Example: Dakota North is claimed as a dependent on her parent's joint return. The North's only income source is wages of $75,000. Dakota starts college in 2011. Of Dakota's $10,000 tuition and fees for the year, she pays $500 and her parents pay $9,500. All $10,000 is considered paid by the parents for purposes of the education credits.

If the parents find their income too high to take advantage of the Hope or Lifetime Learning credit, they should arrange for their child, the student, to take the credit, assuming he/she has enough taxable income to benefit.

According to the Code, it appears this is possible only if the child:

1. Does not qualify as a dependent for purposes of the IRC Sec. 151 exemption deduction; and
2. Pays his/her own tuition expenses.

However, Prop. Reg. 1.25A-1(g) says the child can take the **credit** as long as the parent(s) does not claim him/her as a dependent. In other words, it does not matter if the child actually qualifies as the parent's dependent under IRC Sec. 151, nor does it matter if the parent pays all the tuition.

The fact that the parents fail to claim an exemption that is rightfully theirs does **not** entitle the child to a **dependency deduction** of his/her own.

If a "third party" (someone other than the taxpayer, taxpayer's spouse, or a claimed dependent) makes a payment for tuition costs for the taxpayer, spouse, or a claimed dependent, the student is treated as receiving the payment and then paying the tuition for purposes of the Hope and Lifetime Learning credits. If the expenses relate to a dependent, they are in turn considered paid by the taxpayer on whose return the dependent is claimed.

These nonrefundable credits phase out based on modified AGI. The phase-out amounts may be adjusted annually for inflation. Currently, the AGI phase-out is:

Filing Status	AOTC 2011 AGI Phase-out	Lifetime Learning 2011
MFJ and Surviving Spouse	$160,000–$180,000	$102,000-$122,000
Single and Head of Household	$80,000–$90,000	$51,000-$61,000

Modified AGI is AGI determined without regard to the exclusions from gross income for foreign earned income and foreign housing costs, and the income exclusion for residents of Guam, American Samoa, Northern Mariana Islands, and Puerto Rico.

The credit is **not** available for MFS returns.

Qualified tuition and related expenses are generally the amount upon which the applicable credit is based and include out-of-pocket costs for tuition and fees required for the enrollment or attendance of an eligible student at an eligible educational institution. Such expenses do not include:

1. Expenses paid for any course involving sports, games, or hobbies unless such course is part of the individual's degree program.
2. Expenses such as student activity and health fees, insurance expenses, transportation costs, room and board, or other unrelated expenses, whether or not paid to the eligible educational institution.

Fees for books, supplies, and equipment used in a course of study as well as nonacademic fees would be included in the definition only if they are **paid to the eligible educational institution**. The university book store does not count.

New Law: Per the American Recovery and Reinvestment Act of 2009, the definition of qualified higher education expenses is expanded for 2009 and 2010 to include the purchase of any computer technology or equipment and Internet access and related services for use by the designated beneficiary and the beneficiary's family.

Software designed for sports, games, or hobbies does not qualify unless the software is predominantly educational in nature.

The amount of qualified tuition and related expense for purposes of the education credits must be out-of-pocket costs. Therefore, the otherwise qualified tuition and related expenses for the tax year are reduced by amounts allocable to the tax year paid for the benefit of the student. These reductions include qualified scholarships excludable from gross income under IRC Sec. 117, employer-provided educational assistance excluded from income under IRC Sec. 127, a veteran's educational assistance allowance, an educational assistance allowance for members of the Selected Reserve, or any other educational assistance that is excludable from gross income (other than tax-free gifts and inheritances).

The IRS has privately ruled that a student who included in income educational expenses paid on her behalf by an educational settlement trust was able to include these expenses in the calculation of the education credits, provided they would otherwise qualify.

A taxpayer may not take more than one credit for the same student in the same tax year, but a taxpayer can still end up with more than one credit.

Strategy: Dave and Pat Kidalot earned over $500,000 in 2011 and did not qualify for any education credits. Joe is no longer a dependent because he paid over half of his own support by doing computer work in the family accounting firm. Joe is a freshman and paid $10,000 in tuition. How much can Joe earn in 2011 before incurring a federal tax liability?

Answer: $28,800 ($2,500 AOTC Credit offsets $19,350 of taxable income plus $5,700 standard deduction, plus $3,650 exemption).

In a divorce situation, steps should be taken to ensure that the parent who makes the tuition payment is also eligible to claim the child as a dependent. If the noncustodial parent makes the tuition payments, the custodial parent should consider releasing the claim for the exemption. If the dependency exemption goes to one parent and the other parent pays the tuition, the credit is lost to the paying parent, but may still be claimed by the parent claiming the dependency exemption.

Prepayments of Qualified Higher Education Expense (QHEE) during one tax year for academic periods that begin during the first three months of the following tax year are included in the credit calculation for the year they are paid.

Example: In December 2011, Larry Potts, pays tuition and fees at Wild Hog College for the spring semester that begins in January 2012. For purposes of the AOTC, Larry is eligible to claim the credit in 2011 (cash basis) for the 2012 expenses.

Credits are claimed by completing Form 8863. Neither credit will be allowed unless the taxpayer includes the name and social security number of the eligible student.

See IRS Pub. 970 for a flowchart to determine if the taxpayer can claim the AOTC/Hope credit or Lifetime Learning credit.

Chapter 14 Exercises

Question 1: Child tax credit.

Jamie and Sue have quadruplets. Loren, Jordan, Madison and Taylor were all born on the same day in May of 2003. Jamie and Sue's adjusted gross income is $100,000 in 2011. How much is their child tax credit in 2011?

Question 2: Expenses for purposes of the education credit.

Tom and Janet Jones file a joint return and claim Brad as a dependent. Wages of $75,000 are their only income. Brad starts college in 2011. Of Brad's $6,000 tuition and fees for the year, he pays $1,500 in 2011 and his parents pay $4,500 in 2011. Who is considered to have paid the expenses and who is entitled to any available education credits?

Chapter 14 Exercise Solutions

Question 1: Child tax credit.

Jamie and Sue have quadruplets. Loren, Jordan, Madison and Taylor were all born on the same day in May of 2003. Jamie and Sue's adjusted gross income is $100,000 in 2011. How much is their child tax credit in 2011?

Answer: *$4,000. $1,000 × 4 qualified children.*

Question 2: Expenses for purposes of the education credit.

Tom and Janet Jones file a joint return and claim Brad as a dependent. Wages of $75,000 are their only income. Brad starts college in 2011. Of Brad's $6,000 tuition and fees for the year, he pays $1,500 in 2011 and his parents pay $4,500 in 2011. Who is considered to have paid the expenses and who is entitled to any available education credits?

Answer: *The entire $6,000 is considered paid by the parents in 2011 for purposes of the education credit. Only the parents can claim the education credit; Brad cannot claim any education credit.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

48. When is the earned income credit available for taxpayers without children?

    a. The taxpayer is being claimed as a dependent.

    b. The taxpayer's principal place of abode is within the U.S. for the entire year.

    c. The taxpayer is between 25 and 64 years old.

49. In 2009, Ellie pays $1,000 of qualified adoption expenses in connection with adopting Sally, an eligible child *without* special needs who is a U.S. citizen. In 2010, Ellie spends an additional $2,000, and in 2011, the year the adoption becomes final, she pays another $4,000, making the total adoption expenses $7,000. Ellie's AGI is less than the beginning of the adoption credit phase-out amount. How much adoption credit, if any, can Ellie claim in 2009, 2010, 2011, and 2012?

    a. Zero credit is allowed until 2011 when Ellie claims all of the $7,000 as a credit.

    b. Zero credit is allowed in 2009, $1,000 credit in 2010 and $6,000 credit in 2011.

    c. $1,000 credit in 2009, $2,000 credit in 2010 and $4,000 credit in 2011.

50. Which of the following statements regarding the child tax credit is **incorrect**?

    a. The credit is a nonrefundable personal credit.

    b. Applies to qualifying children (as defined under the uniform definition of a child) up to age 16.

    c. Phases out when AGI reaches a threshold.

51. Tom and Janet Jones file a joint return and claim Brad as a dependent. Wages of $75,000 are their only income. Brad starts college in 2011. Of Brad's $6,000 tuition and fees for the year, he pays $1,500 in 2011 and his parents pay $4,500 in 2011. Which taxpayer(s) are entitled to use what amount of tuition for purposes of claiming the education credits?

    a. The parents and Brad qualify for the education credits using the portion of tuition each paid.

    b. Brad qualifies for the tuition credits using $6,000 of tuition paid.

    c. The parents qualify for the education credits using $6,000 of tuition paid.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

48. When is the earned income credit available for taxpayers without children? **(Page 242)**

    a. The taxpayer is being claimed as a dependent. [This answer is incorrect. The taxpayer(s) must not be claimed as a dependent by another taxpayer for that tax year.]

    b. The taxpayer's principal place of abode is within the U.S. for the entire year. [This answer is incorrect. Taxpayers must have a U.S. abode for more than one-half of the year.]

    c. The taxpayer is between 25 and 64 years old. [This answer is correct. Under current tax law, the earned income credit is available to taxpayers without children if the taxpayer (or if married, either the taxpayer or the spouse) is between 25 and 64 years of age at the end of the year.]

49. In 2009, Ellie pays $1,000 of qualified adoption expenses in connection with adopting Sally, an eligible child *without* special needs who is a U.S. citizen. In 2010, Ellie spends an additional $2,000, and in 2010, the year the adoption becomes final, she pays another $4,000, making the total adoption expenses $7,000. Ellie's AGI is less than the beginning of the adoption credit phase-out amount. How much adoption credit, if any, can Ellie claim in 2009, 2010, 2011, and 2012? **(Page 248)**

    a. Zero credit is allowed until 2011 when Ellie claims all of the $7,000 as a credit. [This answer is incorrect. Only with foreign adoptions must you wait until the year the adoption becomes final to claim the adoption credit.]

    b. Zero credit is allowed in 2009, $1,000 credit in 2010 and $6,000 credit in 2011. [This answer is correct. Because of the one-year delay rule, a credit for the $1,000 of expenses paid in 2009 cannot be claimed until 2010. Similarly, a credit for the 2010 expenses cannot be claimed until 2011. The 2011 expenses can be considered for 2011 because the adoption was final that year.]

    c. $1,000 credit in 2009, $2,000 credit in 2010 and $4,000 credit in 2011. [This answer is incorrect. The one-year delay rule is in effect until the year the adoption is final.]

50. Which of the following statements regarding the child tax credit is **incorrect**? **(Page 252)**

    a. The credit is a nonrefundable personal credit. [This answer is correct. The credit is refundable to the extent of 15% of the taxpayer's earned income in excess of $8,500.]

    b. Applies to qualifying children (as defined under the uniform definition of a child) up to age 16. [This answer is incorrect. The credit applies for qualifying children up through age 16.]

    c. Phases out when AGI reaches a threshold. [This answer is incorrect. The credit phases out when modified AGI levels are reached.]

51. Tom and Janet Jones file a joint return and claim Brad as a dependent. Wages of $75,000 are their only income. Brad starts college in 2011. Of Brad's $6,000 tuition and fees for the year, he pays $1,500 in 2011 and his parents pay $4,500 in 2011. Which taxpayer(s) are entitled to use what amount of tuition for purposes of claiming the education credits? **(Page 258)**

    a. The parents and Brad qualify for the education credits using the portion of tuition each paid. [This answer is incorrect. Brad cannot claim any education credit.]

    b. Brad qualifies for the tuition credits using $6,000 of tuition paid. [This answer is incorrect. The education credits follow the dependency exemption.]

    c. The parents qualify for the education credits using $6,000 of tuition paid. [This answer is correct. The entire $6,000 is considered paid by the parents in 2011 for purposes of the education credit.]

EXAMINATION FOR CPE CREDIT

Chapter 14

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

46. The earned income credit is available for taxpayers:

    a. With qualifying children.

    b. Without qualifying children.

    c. With or without qualifying children.

    d. Do not select this answer choice.

47. Which of the following is correct concerning the adoption credit?

    a. It is a refundable credit for 2011.

    b. It does not carryforward unused amounts.

    c. The credit has an annual limit for qualifying expenses.

    d. The credit is only available in the year the adoption becomes final.

48. Regarding the child tax credit, which of the following is correct for 2011?

    a. It is $1,000 per qualifying child up through age 16.

    b. It is a nonrefundable credit.

    c. The credit is allowed for all dependents meeting the definition of a qualifying child.

    d. The credit is allowed only for the custodial parent.

Chapter 15: Tax Payments

Learning Objective

Completion of this chapter will enable you to:

- Identify when the penalty for underpayment of estimated tax applies and evaluate alternative tax payment options.

Introduction

The two most common ways to pay taxes throughout the year are withholding and quarterly estimated payments. All federal income taxes (FIT) withheld for a taxpayer shown on Forms W-2, W-2G, 1099-R, and any other IRS forms reporting FIT withheld are totaled and reported on line 64 (federal income tax withheld) of Form 1040. Any form showing FIT withheld should always be attached to a paper copy of the Form 1040.

If withholding is not sufficient to avoid the penalty for underpayment of estimated tax, quarterly estimated tax payments are required. Generally, the estimated tax equals the estimated amount of income tax (including alternative minimum tax) plus self-employment (SE) tax less estimated credits and FIT withholding. Form 1040-ES (Payment Voucher) is used to accompany estimated tax payments not made electronically.

Taxpayers who do not pay prescribed amounts of tax during the year through withholding or estimated payments are subject to the penalty for underpayment of estimated tax. The penalty is computed on Form 2210 (Underpayment of Estimated Tax by Individuals, Estates, and Trusts) or Form 2210F (Underpayment of Estimated Tax by Farmers and Fishermen).

Any tax liability in excess of withholding and estimated payments must be paid by the return's due date (determined without extensions). Failure to make such payment may result in penalty and interest charges.

Taxpayers owing tax on their returns may use Form 1040-V (Payment Voucher) to accompany their payments. The original preprinted Form 1040-V or a blank form should be completed and mailed to the IRS with the taxpayer's check and tax return. No penalty exists for not using the payment voucher.

Underpayment of Estimated Tax Penalty

IRC Sec. 6654 provides for a penalty to be added to the tax for any year the taxpayer fails to pay the tax as shown on the return in a "timely manner." The penalty will apply if the taxpayer does not pay at least the smaller of:

1. 90% of the tax shown on the return, or
2. 100% of the tax shown on the prior year return (110% of that amount if not a farmer or fisherman and AGI exceeds $150,000).

Pursuant to IRC Sec. 6654(e) there will be no underpayment penalty if:

1. The tax due on the return is less than $1,000 after the reduction for withholding tax paid, or
2. No fourth installment is made and the taxpayer files the return by the last day of the first month of the following tax year, or

3. During the periods of the operation of certain Title 11 bankruptcy cases there is no penalty imposed.
4. The taxpayer was a U.S. citizen or resident and had no tax liability on the prior year return that covered twelve months.

The penalty is figured separately for each installment due date when the required payment exceeds the amount paid, as adjusted for prior periods of either overpayment or underpayment. The following rules apply:

1. The penalty rate is based on the average market yield of federal securities with three years or less to maturity.
2. The required installment periods are 25% of the required annual payment due on the fifteenth day in the fourth, sixth and ninth months of the tax year and the first month following the close of the tax year.
3. The penalty applies even if there is reasonable cause for the under-payment. It can only be eliminated by statutorily available waivers.
4. All withholding is deemed to be paid evenly over the year with 25% applied to each due date, unless the taxpayer establishes to the contrary.

There are certain exceptions available in the code termed “extension of performance time and relief” which includes:

1. **Taxpayers Living Abroad.** U.S. citizens or residents (including taxpayers in military or naval service) whose tax home is outside the U.S. and Puerto Rico are automatically granted an extension to file their tax return until June 15. Under this provision:
    a. Eligible taxpayers living abroad are allowed an automatic extension period for filing their returns, paying any tax due and filing claims for refunds. The deadline is extended for two months, until June 15.
    b. Other military, support personnel, Red Cross personnel, accredited correspondents, and civilian personnel under military direction may be eligible for the extension on income taxes.
    c. To notify the IRS about special status:
        1) File return with “Combat Zone” at the top of the form along with the deployment date.
        2) Contact the IRS at **combatzone@irs.gov**—include the name, date of birth and date of deployment of the service member. Do not include the social security number.
        3) Call the IRS helpline at 800-829-1040.
    d. Service members not in a combat zone may qualify to defer the payment of income tax that comes due before or during their military service if they notify the IRS that their ability to pay the income taxes has been materially affected by their military service.
2. Extensions are also provided for in federally declared disaster areas.

The taxpayer can let the IRS compute the underpayment penalty, but the IRS will not apply any eligible waivers or abatements to the penalty nor use the annualization method.

The taxpayer may obtain a waiver of the penalty when:

1. The failure to pay was due to casualty, disaster or other unusual circumstances. The standard IRS is charged with is "it would be inequitable or against good conscience to impose the penalty." Examples of waivers granted are:
    a. Books and records destroyed by casualty
    b. Death or serious illness of the taxpayer
    c. The liability of the taxpayer was seriously overstated on the return
    d. The mental incapacitation of the taxpayer (in the case of a joint return this applies to either taxpayer)
2. The IRS **cannot** waive the penalty for:
    a. Financial hardship,
    b. Bankruptcy (but in certain Title 11 bankruptcy cases penalty is not assessed),
    c. Failure to make "allowance or set aside" the funds to remit the payments.
3. The penalty can be waived for the first two years after the taxpayer retires but only after reaching age 62 or becoming disabled. IRC Sec. 6654(3)(B) applies when:
    a. The underpayment was due to reasonable cause and not willful neglect.
    b. This abatement is not available for the conversion of a traditional IRA to a Roth IRA.

Annualization is an alternative method of calculating the required estimated tax liability. The annualized method works best when the taxpayer's income is not earned equally throughout the year. Annualization is meant to reflect the actual tax liability for the income earned for each estimated tax payment period. Prepare schedule A1 from Form 2210 to determine the required installment for each payment period.

The income for the period is calculated through the end of the month prior to the due date of the required installment to calculate the installment per the table below.

	Installment Due	Income Annualized:	
		From	**Through**
1	April 15	January 1	March 31
2	June 15	January 1	May 31
3	September 15	January 1	August 31
4	January 15	January 1	December31

Most of our tax software today will make the annualization calculations on Schedule A1 of Form 2210 with the furnishing of the respective income, deductions and SE income amounts for the periods as indicated above.

Line	Description		(a)	(b)	(c)	(d)
1	Enter your adjusted gross income for each period (see instructions). (Estates and trusts, enter your taxable income without your exemption for each period)	1	13,998	43,330	57,328	277,292
2	Annualization amounts. (Estates and trusts, see instructions)	2	4	2.4	1.5	1
3	Annualized income. Multiply line 1 by line 2	3	55,992	103,992	85,992	277,292
4	If you itemize, enter itemized deductions for the period shown in each column. All others enter -0-, and skip to line 7. **Exception:** Estates and trusts, skip to line 9 and enter amount from line 3	4	0	0	0	0
5	Annualization amounts	5	4	2.4	1.5	1
6	Multiply line 4 by line 5 (see instructions if line 3 is more than $79,975)	6	0	0	0	0
7	In each column, enter the full amount of your standard deduction from Form 1040, line 40, or Form 1040A, line 24 (Form 1040NR or 1040NR-EZ filers, enter -0-. **Exception:** Indian students and business apprentices, see instructions.)	7	10,300	10,300	10,300	10,300
8	Enter the **larger** of line 6 or line 7	8	10,300	10,300	10,300	10,300
9	Subtract line 8 from line 3	9	45,692	93,692	75,692	266,992

Each period will be adjusted to its "annual" equivalent and the required estimate is calculated for the period considering the amount of estimates from prior periods and applying any continuing excess prior period payments or shortfalls.

All items of income and expense for the annualization period must be calculated to arrive at the adjusted gross income, SE tax and deductions for the period.

Like the filing of the tax return at year end the taxpayer can use the personal deductions that are most advantageous for that taxpayer, standard versus itemized.

Income retains its nature even with the calculation that annualizes that amount, i.e., ordinary versus capital gain.

Credits, exemptions, self-employment tax and EITC will apply based on the annualized amounts for the period being calculated.

Example: Joe Shareholder has $50,000 of wages subject to $7,500 of withholding for the year. He earned $5,000 in interest and dividend income evenly throughout the year. He has a K-1 indicating distributive net income of $40,000 with NO distributions during the year. No estimates were paid. His total tax liability for the year is $18,339. The penalty is $473 if the preparer does not consider the annualized income installment method.

If Joe's preparer takes advantage of the annualizing method he would calculate the following income per installment period:

	March 31	**May 31**	**August 31**	**December 31**
Wages	12,500	20,833	33,333	50,000
Int and Dividends	1,250	2,083	3,333	5,000
K-1	0	0	0	40,000
Withholding	1,875	3,125	5,000	7,000

Section A—Figure Your Underpayment		Payment Due Dates			
		(a) 4/15/11	(b) 6/15/11	(c) 9/15/11	(d) 1/15/12
18 Required installments. If box C in Part II applies, enter the amounts from Schedule AI, line 25. Otherwise, enter 25% (.25) of line 9, Form 2210, in each column	18	1,845	1,840	1,843	10,977

Allocating Estimated Tax Payments in the Year of Divorce

Divorcing/divorced taxpayers may allocate estimated tax payments in any manner agreeable to them.

In an equitable distribution state, absent an agreement, the estimated payments may be divided in proportion to each spouse's separate tax liability.

In a community property state, to the extent that the tax payments are made from community property, the amounts are divided equally between the parties.

Each spouse should attach a schedule to their separately filed returns detailing the total amount of tax estimates paid, the social security numbers of each spouse, and the amounts and explanations of the allocation method.

When a change in marital status has occurred, a tax practitioner is obligated to follow certain procedures to determine current year tax estimates using the prior-year safe-harbor method.

- For taxpayers who were not married in 2011 but plan to file a joint return in 2012, estimated tax payments should be based upon the total of their 2010 tax liabilities.
- For taxpayers who were married in 2011 but are divorced in 2012, each taxpayer's share of the liability must be computed as follows:
  - Compute the tax each spouse would have paid in 2011 had they filed separate returns.
  - Multiply the 2011 joint tax liability by the following fraction:

$$\frac{\text{Each Taxpayer's Separate Liability}}{\text{Total of Husband's and Wife's Separate Tax Liabilities}}$$

Example: Ken and Ethel were married in 2011 but divorced in 2012. For 2011, they filed a joint return that had a total tax liability of $9,000. Had they filed separately in 2011, Ken's tax would have been $6,000; Ethel's $4,000. Since Ken will file separately in 2012, his "safe harbor" estimated tax of $5,400 is computed as follows: [6,000 ÷ (6,000 + 4,000)] × 9,000 = 5,400.

Special Benefits to Farmers and Fishermen

The following special estimated tax rules apply to qualifying farmers and fishermen:

1. In lieu of paying quarterly estimates, farmers can pay 100% of the prior year's tax (or 66⅔% of current year) on January 15 of the following year and file the tax return with the balance due on April 15, or
2. Can skip making any estimated tax payments, with no penalty, so long as they file their return and pay all tax due by March 1 of the following year.
3. Penalties for underpayment are at a special reduced rate, as calculated on Form 2210F.

A farmer or fisherman qualifies if at least two thirds of total gross income was from farming or fishing during the year.

Gross income from farming includes:

- Gross farm income from Schedule F
- Gross farm rental income from Form 4835
- Gross farm income from Schedule E, Parts II and III
- Gains from the sale of livestock used for draft, breeding, sport or dairy purposes reported on Form 4797

Gross income from farming does not include:

- Gains from sales of farmland and depreciable farm equipment
- Income received from contract grain harvesting and hauling with workers and machines furnished by the taxpayer

Optional Tax Payment Methods

General Payment Options

Any tax liability in excess of withholding and estimated payments must be paid by the return's due date (determined without extensions). Failure to pay may result in penalties and interest charges. There are some options available to help taxpayers pay their balances due other than the traditional payment by check or money order. Individuals can now pay their taxes through the Internet using the Electronic Federal Tax Payment System (EFTPS). In addition, taxpayers may pay their taxes with a credit card or, if they cannot afford to pay the full balance due, they may enter into an installment agreement with the IRS. Taxpayers filing their returns electronically have the option of using the direct debit method of payment whereby the tax payment is electronically withdrawn from their financial account simultaneously with e-filing the return.

Paying Taxes via the Internet

Electronic payment options are becoming increasingly popular with taxpayers. The IRS provides a method for individual taxpayers to pay taxes via the Internet using the Electronic Federal Tax Payment System (EFTPS).

EFTPS offers several advantages. It is convenient, free to taxpayers (although taxpayers should check with their financial institution for any charges they may levy), payments can be scheduled in advance, and it does not have to be used in conjunction with an e-filed return. Individual taxpayers can file a paper return and use EFTPS. The system is available 24 hours a day, 7 days a week. In addition to paying estimated tax, individuals can use EFTPS to pay a balance due with their return.

Recognizing that security is a concern, the IRS has stated that the EFTPS Internet site exceeds private industry best practices with designs for prevention, detection and containment of security breaches. Individuals simply enroll online at **www.eftps.gov**. Within 15 business

days, the taxpayer should receive a confirmation kit by mail with instructions for obtaining a password. Also, a personal identification number (PIN) will be mailed separately. Additional information can be obtained at the website or by calling 1-800-316-6541.

Paying Taxes with a Credit Card

The IRS has authorized the use of credit cards for four types of payments: (1) the current year balance due on a Form 1040 return, (2) a projected current year balance due on request for automatic extension to file Form 1040, (3) estimated tax payments, and (4) certain installment agreement payments.

Taxpayers who wish to use a credit card (American Express, Discover, MasterCard, Visa) to pay their tax liability must contact either of the two independent companies authorized to process such transactions. Official Payments Corp. can be contacted at **www.officialpayments.com** or at 1-877-754-4413. Link2Gov Corporation's website is **www.PAY1040.com** and phone number is 1-888-658-5465. This method of payment may be used regardless of the method taxpayers use to file their returns (whether electronically, online, or by paper). There are also certain software vendors that will offer credit card payment options as a part of their electronic filing programs. For more information, see **www.irs.gov**.

If the tax due with Form 1040 is paid by credit card before the return is filed, the confirmation number provided by the processing company and the amount charged (not including any service fees) should be entered on the top left hand corner of page one of the return. That confirmation number, along with the taxpayer's credit card statement can be used to substantiate the payment.

Generally, payment of tax by credit card is deemed made when the issuer of the card properly authorizes the transaction. If the IRS does not actually receive payment (e.g., the cardholder refuses to pay and the credit card company charges it back to the IRS), the taxpayer remains liable for the payment of tax, penalties, and additions as if the payment had not been made.

When paying by credit card, the private company that processes the transaction charges a fee. The IRS has stated that this fee is considered a nondeductible personal expense under IRC Sec. 262. The fee varies with the amount of the taxes charged and increases as the amount increases.

Installment Agreements

Another option for taxpayers lacking the funds to pay their taxes due with the return is to request an installment arrangement from the IRS. Form 9465 is the application to the IRS requesting an installment payment arrangement; the IRS will notify the taxpayer within 30 days if the request is approved or denied, or if the IRS requires additional information. The IRS charges taxpayers a $105 fee for an installment agreement if the nondirect debit option is selected. This fee is reduced to $52 if the direct debit option is selected, and may be reduced to $43 for certain low income taxpayers. Eligibility for the reduced $43 fee is determined automatically from the taxpayer's current tax return. The fee must be paid in order for the installment agreement to be valid. Once approved, the taxpayer will receive a notice containing a payment voucher showing the first monthly payment and fee. The taxpayer should pay the entire amount and check the box indicating the fee is included in the payment.

Taxpayers can request full or partial payment of taxes due for installment arrangements. However, the partial payment does not relieve the taxpayer of the amount of taxes, interest, or penalties owed. Generally, during the period when installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance. If the IRS accepts a partial payment installment agreement, IRC Sec. 6159(d) requires the subsequent review of the taxpayer's records at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

The failure-to-pay penalty is half the usual rate (0.25% instead of 0.50%) for any month in which an installment payment agreement with the IRS is in effect. Upon receipt of the proposed agreement, it may take the IRS several weeks to accept it. The penalty is not reduced until the agreement is effective, which is upon acceptance and not receipt by the IRS. If an installment agreement can be secured and accepted by phone, the IRS will immediately reduce the penalty rate. Thus, taxpayers may reduce their penalty rate much sooner by obtaining their installment agreement approval by telephone.

The IRS is *required* to enter into an installment agreement with a taxpayer if (1) the aggregate amount of the taxpayer's liability (without regard to penalty, interest, and other additions to tax) does not exceed $10,000; (2) the taxpayer has not failed to file any required income tax return or pay the tax shown on those returns in the five preceding tax years; (3) the taxpayer has not entered into an installment agreement in the five preceding tax years; (4) the IRS determines that the taxpayer is unable to pay his liability in full when due; (5) the installment agreement requires full payment of the liability within three years; and (6) the taxpayer complies with all applicable income tax provisions while the agreement is in effect (payment of tax, filing of returns, etc.).

The IRS has announced (IR 1999-36) that it will grant installment agreements to taxpayers that agree to pay an outstanding tax liability of less than $25,000 within a 60-month period even though it is not required by law to do so.

Online Payment Agreement (OPA) for Delinquent Taxes

Individuals who owe $25,000 or less in combined tax, penalties, and interest can use the online payment agreement (OPA) application to request a payment agreement. This application allows the taxpayer or his authorized representative to self-qualify, apply for an installment agreement, and receive immediate notification of approval. There may be times when the taxpayer will need to mail in paperwork or speak with the IRS before installment agreement eligibility is finalized. If that is the case, the OPA application will give the taxpayer an address or a toll-free phone number to reach them.

Taxpayers can access the OPA application at **www.irs.gov/individuals/article/0,,id=149373,00.html**. The OPA allows the taxpayer to either pay in full, obtain a short-term extension of up to 120 days, or request a monthly payment plan. The standard installment agreement fee will be applied to the monthly payment plan but not to the other two options.

Chapter 15 Exercises

Question 1: Penalty for underpayment of estimated tax.

Bill and Bonnie Green's 2011 AGI and tax liability were $165,000 and $35,000, respectively. They both quit their jobs on January 2, 2012, to open a shop specializing in Christmas decorations. Because of the seasonal nature of their business, most of their 2012 income was received in the last three months of the year. Since they did not expect the shop to make much of a profit the first year, the practitioner based their 2012 estimated payments on 90% of their projected 2012 tax liability. They made estimated payments of $1,000 on April 17, June 15, and September 17. However, the shop did a landslide business in the last quarter. At year-end, they made a rough estimate of their 2012 tax liability and made a fourth quarter estimated payment on December 29 of $30,000. Total estimated tax payments for the year, then, were $33,000.

Their 2012 return showed a total liability (including SE tax) of $30,000. The return was timely filed and the Greens requested a refund of the $3,000 overpayment.

Are the Greens potentially subject to a penalty for underpayment of estimated tax? Why or why not? If the penalty applies, what might the Greens do to mitigate or eliminate it?

Question 2: Client unable to pay income tax liability.

Phil and Margaret Smith's 2011 tax return shows unpaid tax of $5,000. Because they do not have the cash to pay the tax, they want to postpone filing the return until December 2012 when Phil will receive his annual bonus. What advice can you give that would help the Smiths with their dilemma?

Question 3: Estimating tax liability on an extension to file a tax return.

You prepare the Form 1040 for Ginger and Errol Patton who are shareholders in an S corporation. On the due date of their 2011 return (April 15, 2012), they have all the necessary information to estimate their tax liability except the Schedule K-1 from the S corporation. The practitioner preparing the Form 1120S provides the Pattons with an estimate of their share of the corporation's 2011 loss. Based on that information and all other information available to them on April 15, 2012, you estimate the balance due of their 2011 tax liability to be $25,000. On April 15, 2012, they file Form 4868 and pay the $25,000. In August 2012, the Pattons receive their K-1 from the S corporation and file their return. Because the S corporation loss was less than anticipated, they owe an additional $10,000 when they file their return.

Will the Patton's extension be valid even though their tax is $10,000 more than shown on the extension request? What would your answer be if an estimate of the S corporation's income for the year had not been available?

Chapter 15 Exercise Solutions

Question 1: Penalty for underpayment of estimated tax.

Bill and Bonnie Green's 2011 AGI and tax liability were $165,000 and $35,000, respectively. They both quit their jobs on January 2, 2012, to open a shop specializing in Christmas decorations. Because of the seasonal nature of their business, most of their 2012 income was received in the last three months of the year. Since they did not expect the shop to make much of a profit the first year, the practitioner based their 2012 estimated payments on 90% of their projected 2012 tax liability. They made estimated payments of $1,000 on April 17, June 15, and September 17. However, the shop did a landslide business in the last quarter. At year-end, they made a rough estimate of their 2012 tax liability and made a fourth quarter estimated payment on December 29 of $30,000. Total estimated tax payments for the year, then, were $33,000.

Their 2012 return showed a total liability (including SE tax) of $30,000. The return was timely filed and the Greens requested a refund of the $3,000 overpayment.

Are the Greens potentially subject to a penalty for underpayment of estimated tax? Why or why not? If the penalty applies, what might the Greens do to mitigate or eliminate it?

Answer: *Even though the Greens paid in over 90% of their liability for the year, they are still potentially subject to the underpayment penalty for the first three quarters. An overpayment late in the year does not eliminate the penalties for the earlier quarters.*

To mitigate each quarter's penalty, the taxpayer may use the exception that results in the lowest required payment (i.e., a different exception can be used each quarter). Here, use of the annualization method would help reduce the penalty.

Question 2: Client unable to pay income tax liability.

Phil and Margaret Smith's 2011 tax return shows unpaid tax of $5,000. Because they do not have the cash to pay the tax, they want to postpone filing the return until December 2012 when Phil will receive his annual bonus. What advice can you give that would help the Smiths with their dilemma?

Answer: *The recommendations you might make to the Smiths include the following:*

- *File a valid application for automatic extension showing the full amount of tax (properly estimated). Under this option, if payment is delayed beyond April 15, interest and the failure to pay penalty will accrue from April 15 and continue to apply until the tax is paid. Filing the return or a valid extension by April 15 avoids the failure to file penalty even if all or part of the tax due is not paid. However, the failure to pay penalty and interest charges cannot be avoided—these continue to accrue until the tax is paid. If an extension is filed on April 15, the practitioner should recommend the clients file the return by October 15. If the clients still cannot pay the tax or can pay only a portion of it, Form 9465 (Installment Agreement Request) should be attached to the return.*
- *File the return on time (without extension) and attach a Form 9465 (Installment Agreement Request). This option requires making a deferred payment agreement with the IRS. Interest and late payment penalties will be assessed on any tax not paid by April 15.*

- *Determine whether the taxpayers qualify for an extension to pay the tax under IRC Sec. 6161 because of undue hardship, or under IRC Sec. 7508A because of a presidentially declared disaster, terrorist act, or military action. This would allow the taxpayer to avoid the failure to pay penalty but not the interest charge. Section 6161 relief is difficult to obtain because of the restricted definition of hardship.*
- *Because both the failure to pay penalty and interest charges apply to late payment of tax, you could explain that borrowing from an institutional lender might be less expensive than paying the IRS penalties plus interest. IRS penalties are nondeductible. Interest expense associated with an individual's federal tax liability, whether paid to the IRS or to a commercial lender, generally is personal nondeductible interest. However, if the taxpayer finances the payment with a home equity loan, the interest may be deductible for regular tax (but not AMT) purposes regardless of how the proceeds are used.*
- *You could discuss the possibility of paying the tax with a credit card. Applicable finance charges (according to the credit card agreement) and processing fees will apply, but if the Smiths have a low interest rate card, then these will be kept to a minimum until the balance is paid in full with the December bonus. The accrued interest on the credit card is personal nondeductible interest. However, certain credit cards allow the taxpayer to earn airline miles and other incentives, which may offer some advantage to using these cards.*

Question 3: Estimating tax liability on an extension to file a tax return.

You prepare the Form 1040 for Ginger and Errol Patton who are shareholders in an S corporation. On the due date of their 2011 return (April 15, 2012), they have all the necessary information to estimate their tax liability except the Schedule K-1 from the S corporation. The practitioner preparing the Form 1120S provides the Pattons with an estimate of their share of the corporation's 2011 loss. Based on that information and all other information available to them on April 15, 2012, you estimate the balance due of their 2011 tax liability to be $25,000. On April 15, 2010, they file Form 4868 and pay the $25,000. In August 2012, the Pattons receive their K-1 from the S corporation and file their return. Because the S corporation loss was less than anticipated, they owe an additional $10,000 when they file their return.

Will the Patton's extension be valid even though their tax is $10,000 more than shown on the extension request? What would your answer be if an estimate of the S corporation's income for the year had not been available?

Answer: *The Patton's estimate was based on the information available to them on April 15, 2012. A review of their records by the IRS would verify this. Therefore, they filed a valid extension.*

The same answer should be true even if a projection of the S corporation's income had not been available, so long as you based the tax estimate on all of the information that was available to them.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

52. Underpayment penalties can be avoided if:

    a. The taxpayer pays quarterly estimated tax payments to equal 100% (110% if AGI exceeds $150,000) of the prior year's tax liability.

    b. The taxpayer's only source of income is from farming and the return is filed by April 15.

    c. The taxpayer has a balance due after withholding that is less than $2,000.

    d. The taxpayer pays any tax liability in excess of withholding and estimated payments by October 15.

53. Which of the following options (and consequences) to paying taxes via withholding will reduce a client's potential underpayment penalty?

    a. Paying taxes at year-end via the Internet.

    b. The taxpayer is able to determine the income earned per estimate tax payment period.

    c. The taxpayer files an extension for filing his/her income tax return.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this chapter. **(References are in parentheses.)**

52. Underpayment penalties can be avoided if: **(Page 269)**

    a. The taxpayer pays quarterly estimated tax payments to equal 100% (110% if AGI exceeds $150,000) of the prior year's tax liability. [This answer is correct. The safe harbor under Code Sec. 6654 allows taxpayers to pay 100% or 110% of the prior year's tax liability and avoid the underpayment penalty.]

    b. The taxpayer's only source of income is from farming and the return is filed by April 15. [This answer is incorrect. Qualified farmers must file and pay taxes due by March 1.]

    c. The taxpayer has a balance due after withholding that is less than $2,000. [This answer is incorrect. No underpayment penalty is assessed if the balance due is under $1,000.]

    d. The taxpayer pays any tax liability in excess of withholding and estimated payments by October 15. [This answer is incorrect. Payment must be made by the return's due date (determined without extensions).]

53. Which of the following options (and consequences) to paying taxes via withholding will reduce a client's potential underpayment penalty? **(Page 271)**

    a. Paying taxes at year-end via the Internet. [This answer is incorrect. Using the Internet via EFTPS is convenient but does not have an impact on the requirement to make estimated tax payments.]

    b. The taxpayer is able to determine the income earned per estimate tax payment period. [This answer is correct. The ability to annualize income when income is earned unevenly can reduce the underpayment penalty.]

    c. The taxpayer files an extension for filing his/her income tax return. [This answer is incorrect. An extension to file does not relieve the taxpayer of the need to pay timely and make estimated tax payments.]

EXAMINATION FOR CPE CREDIT

Chapter 15

Determine the best answer for each question below, then log onto our Online Grading System at **cl.thomsonreuters.com/ogs** to record your answers.

49. Lucy owns a small bakery for dogs which is her sole source of income. Lucy's AGI for 2011 was $125,000. Her required estimated tax payments for 2012 are _________ of her prior year's tax.

    a. 75%.

    b. 90%.

    c. 100%.

    d. 110%.

50. A client is in Brazil on April 15, 2011. Which statement below is accurate?

    a. The client has an additional two months to file his/her tax return and make any payments for tax due without penalty if their tax home is not in the U.S.

    b. The client has an additional two months to file his/her tax return and make any payments for tax due without penalty if they are out of the country on this date as a civilian.

    c. Any U.S. citizen may be granted a two-month extension for filing a return if physically out of the country on April 15.

    d. Only individuals serving in a combat zone are entitled to an extension of time to file and time to pay any tax due without penalty.

Appendix

Form **1040** Department of the Treasury—Internal Revenue Service (99)

U.S. Individual Income Tax Return 2011

OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2011, or other tax year beginning , 2011, ending , 20

See separate instructions.

Your first name and initial	Last name		**Your social security number**
If a joint return, spouse's first name and initial	Last name		**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).			**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ **You** ☐ **Spouse**
Foreign country name	Foreign province/county	Foreign postal code	

Filing Status

Check only one box.

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

Exemptions

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

Boxes checked on 6a and 6b

c **Dependents:**

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

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

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

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

Income

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

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

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

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

Adjusted Gross Income

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

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2011)

Tax and Credits

Standard Deduction for—
• People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.
• All others:
Single or Married filing separately, $5,800
Married filing jointly or Qualifying widow(er), $11,600
Head of household, $8,500

Line	Description		
38	Amount from line 37 (adjusted gross income)		38
39a	Check if: ☐ **You** were born before January 2, 1947, ☐ Blind. ☐ **Spouse** was born before January 2, 1947, ☐ Blind. } **Total boxes checked ▶ 39a**		
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ **39b** ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		40
41	Subtract line 40 from line 38		41
42	**Exemptions.** Multiply $3,700 by the number on line 6d		42
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43
44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ 962 election		44
45	**Alternative minimum tax** (see instructions). Attach Form 6251		45
46	Add lines 44 and 45 ▶		46
47	Foreign tax credit. Attach Form 1116 if required	47	
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Education credits from Form 8863, line 23	49	
50	Retirement savings contributions credit. Attach Form 8880	50	
51	Child tax credit (see instructions)	51	
52	Residential energy credits. Attach Form 5695	52	
53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐ ______	53	
54	Add lines 47 through 53. These are your **total credits**		54
55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶		55

Other Taxes

Line	Description	
56	Self-employment tax. Attach Schedule SE	56
57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919	57
58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58
59a	Household employment taxes from Schedule H	59a
b	First-time homebuyer credit repayment. Attach Form 5405 if required	59b
60	Other taxes. Enter code(s) from instructions ______	60
61	Add lines 55 through 60. This is your **total tax** ▶	61

Payments

If you have a qualifying child, attach Schedule EIC.

Line	Description		
62	Federal income tax withheld from Forms W-2 and 1099	62	
63	2011 estimated tax payments and amount applied from 2010 return	63	
64a	**Earned income credit (EIC)**	64a	
b	Nontaxable combat pay election **64b**		
65	Additional child tax credit. Attach Form 8812	65	
66	American opportunity credit from Form 8863, line 14	66	
67	First-time homebuyer credit from Form 5405, line 10	67	
68	Amount paid with request for extension to file	68	
69	Excess social security and tier 1 RRTA tax withheld	69	
70	Credit for federal tax on fuels. Attach Form 4136	70	
71	Credits from Form: **a** ☐ 2439 **b** ☐ 8839 **c** ☐ 8801 **d** ☐ 8885	71	
72	Add lines 62, 63, 64a, and 65 through 71. These are your **total payments** ▶		72

Refund

Direct deposit? See instructions.

Line	Description		
73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you **overpaid**		73
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		74a
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
75	Amount of line 73 you want **applied to your 2012 estimated tax** ▶	75	

Amount You Owe

Line	Description		
76	**Amount you owe.** Subtract line 72 from line 61. For details on how to pay, see instructions ▶		76
77	Estimated tax penalty (see instructions)	77	

Third Party Designee

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

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

Sign Here

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

Joint return? See instructions.
Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶		Firm's EIN ▶		
Firm's address ▶		Phone no.		

SCHEDULE A (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedule A (Form 1040).

OMB No. 1545-0074

2011

Attachment Sequence No. **07**

Name(s) shown on Form 1040 | **Your social security number**

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

SCHEDULE B (Form 1040A or 1040)

Department of the Treasury Internal Revenue Service (99)

Interest and Ordinary Dividends

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

OMB No. 1545-0074

2011

Attachment Sequence No. 08

Name(s) shown on return | **Your social security number**

Part I Interest

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ▶	1	
2	Add the amounts on line 1	2	
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a ▶	4	

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

			Amount
5	List name of payer ▶	5	
6	Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a ▶	6	

Note. If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

(See instructions on back.)

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
7a	At any time during 2011, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
	If "Yes," are you required to file Form TD F 90-22.1 to report that financial interest or signature authority? See Form TD F 90-22.1 and its instructions for filing requirements and exceptions to those requirements		
b	If you are required to file Form TD F 90-22.1, enter the name of the foreign country where the financial account is located ▶		
8	During 2011, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 17146N **Schedule B (Form 1040A or 1040) 2011**

SCHEDULE H (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

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

OMB No. 1545-1971

2011

Attachment Sequence No. **44**

Name of employer

Social security number

Employer identification number

A Did you pay **any one** household employee cash wages of $1,700 or more in 2011? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions before you answer this question.)

☐ **Yes.** Skip lines B and C and go to line 1.
☐ **No.** Go to line B.

B Did you withhold federal income tax during 2011 for any household employee?

☐ **Yes.** Skip line C and go to line 5.
☐ **No.** Go to line C.

C Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 2010 or 2011 to **all** household employees? (**Do not** count cash wages paid in 2010 or 2011 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Do not file this schedule.
☐ **Yes.** Skip lines 1-7 and go to line 8. (Calendar year taxpayers having no household employees in 2011 **do not** have to complete this form for 2011.)

Part I Social Security, Medicare, and Federal Income Taxes

Line	Description	Box	Amount
1	Total cash wages subject to social security taxes	1	
2	Social security taxes. Multiply line 1 by 10.4% (.104)	2	
3	Total cash wages subject to Medicare taxes	3	
4	Medicare taxes. Multiply line 3 by 2.9% (.029)	4	
5	Federal income tax withheld, if any	5	
6	**Total social security, Medicare, and federal income taxes.** Add lines 2, 4, and 5	6	

7 Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 2010 or 2011 to **all** household employees? (**Do not** count cash wages paid in 2010 or 2011 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Include the amount from line 6 above on Form 1040, line 59a. If you are not required to file Form 1040, see the line 7 instructions.

☐ **Yes.** Go to line 8.

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 12187K **Schedule H (Form 1040) 2011**

Part II Federal Unemployment (FUTA) Tax

		Yes	No
8 Did you pay unemployment contributions to only one state? (If you paid contributions to a credit reduction state, see instructions and check "No.")	8		
9 Did you pay all state unemployment contributions for 2011 by April 17, 2012? Fiscal year filers see instructions	9		
10 Were all wages that are taxable for FUTA tax also taxable for your state's unemployment tax?	10		

Next: If you checked the **"Yes"** box on **all** the lines above, complete Section A.
If you checked the **"No"** box on **any** of the lines above, skip Section A and complete Section B.

Section A

11 Name of the state where you paid unemployment contributions ▶ ____________

12 Contributions paid to your state unemployment fund 12

13 Total cash wages subject to FUTA tax 13

14 **FUTA tax.** Multiply the portion of the wages on line 13 paid before July 1 by .008. Multiply the portion of the wages on line 13 paid after June 30 by .006. Enter the sum of those two amounts on line 14, skip Section B, and go to line 23 14

Section B

15 Complete all columns below that apply (if you need more space, see instructions):

(a) Name of state	(b) Taxable wages (as defined in state act)	(c) State experience rate period		(d) State experience rate	(e) Multiply col. (b) by .054	(f) Multiply col. (b) by col. (d)	(g) Subtract col. (f) from col. (e). If zero or less, enter -0-.	(h) Contributions paid to state unemployment fund
		From	To					

16 Totals 16

17 Add columns (g) and (h) of line 16 17

18 Total cash wages subject to FUTA tax (see the line 13 instructions) 18

19 Multiply the portion of the wages on line 18 paid before July 1 by 6.2% (.062). Multiply the portion of the wages on line 18 paid after June 30 by 6.0% (.060). Enter the sum of those amounts on line 19 19

20 Multiply line 18 by 5.4% (.054) 20

21 Enter the **smaller** of line 17 or line 20 . . . .
(Employers in a credit reduction state must use the worksheet on page H-7 and check here) . ☐ 21

22 **FUTA tax.** Subtract line 21 from line 19. Enter the result here and go to line 23 22

Part III Total Household Employment Taxes

23 Enter the amount from line 6. If you checked the "Yes" box on line C of page 1, enter -0- 23

24 Add line 14 (or line 22) and line 23 24

25 Are you required to file Form 1040?

☐ **Yes. Stop.** Include the amount from line 24 above on Form 1040, line 59a. **Do not** complete Part IV below.

☐ **No.** You may have to complete Part IV. See instructions for details.

Part IV Address and Signature— Complete this part **only** if required. See the line 25 instructions.

Address (number and street) or P.O. box if mail is not delivered to street address | Apt., room, or suite no.

City, town or post office, state, and ZIP code

Under penalties of perjury, I declare that I have examined this schedule, including accompanying statements, and to the best of my knowledge and belief, it is true, correct, and complete. No part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments to employees. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Employer's signature ▶ Date

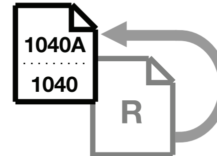
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

Schedule R (Form 1040A or 1040)

Department of the Treasury Internal Revenue Service (99)

Credit for the Elderly or the Disabled

Complete and attach to Form 1040A or 1040.



OMB No. 1545-0074

2011

Attachment Sequence No. 16

Name(s) shown on Form 1040A or 1040 | **Your social security number**

You may be able to take this credit and reduce your tax if by the end of 2011:

- You were age 65 or older **or** • You were under age 65, you retired on **permanent and total** disability, and you received taxable disability income.

But you must also meet other tests. See instructions.

TIP In most cases, the IRS can figure the credit for you. See instructions.

Part I Check the Box for Your Filing Status and Age

If your filing status is:	And by the end of 2011:	Check only one box:
Single, Head of household, or Qualifying widow(er)	**1** You were 65 or older	**1** ☐
	2 You were under 65 and you retired on permanent and total disability . .	**2** ☐
Married filing jointly	**3** Both spouses were 65 or older	**3** ☐
	4 Both spouses were under 65, but only one spouse retired on permanent and total disability	**4** ☐
	5 Both spouses were under 65, and both retired on permanent and total disability	**5** ☐
	6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability	**6** ☐
	7 One spouse was 65 or older, and the other spouse was under 65 and **not** retired on permanent and total disability	**7** ☐
Married filing separately	**8** You were 65 or older and you lived apart from your spouse for all of 2011 .	**8** ☐
	9 You were under 65, you retired on permanent and total disability, and you lived apart from your spouse for all of 2011	**9** ☐

Did you check box 1, 3, 7, or 8?

Yes ▶ Skip Part II and complete Part III on the back.

No ▶ Complete Parts II and III.

Part II Statement of Permanent and Total Disability (Complete **only** if you checked box 2, 4, 5, 6, or 9 above.)

If: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed or got a statement for tax years after 1983 and your physician signed line B on the statement, **and**

2 Due to your continued disabled condition, you were unable to engage in any substantial gainful activity in 2011, check this box . . . . ▶ ☐

- If you checked this box, you do not have to get another statement for 2011.
- If you **did not** check this box, have your physician complete the statement in the instructions. You **must** keep the statement for your records.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11359K **Schedule R (Form 1040A or 1040) 2011**

Part III Figure Your Credit

10 **If you checked (in Part I):** **Enter:**
Box 1, 2, 4, or 7 . . . . $5,000
Box 3, 5, or 6 . . . . $7,500
Box 8 or 9 . . . . $3,750
} **10**

Did you check box 2, 4, 5, 6, or 9 in Part I?
- **Yes** ▶ You **must** complete line 11.
- **No** ▶ Enter the amount from line 10 on line 12 and go to line 13.

11 **If you checked (in Part I):**
- Box 6, add $5,000 to the taxable disability income of the spouse who was under age 65. Enter the total.
- Box 2, 4, or 9, enter your taxable disability income.
- Box 5, add your taxable disability income to your spouse's taxable disability income. Enter the total.

} **11**

TIP For more details on what to include on line 11, see *Figure Your Credit* in the instructions.

12 If you completed line 11, enter the **smaller** of line 10 or line 11. **All others,** enter the amount from line 10 . . . . **12**

13 Enter the following pensions, annuities, or disability income that you (and your spouse if filing jointly) received in 2011.

a Nontaxable part of social security benefits and nontaxable part of railroad retirement benefits treated as social security (see instructions). **13a**

b Nontaxable veterans' pensions and any other pension, annuity, or disability benefit that is excluded from income under any other provision of law (see instructions). **13b**

c Add lines 13a and 13b. (Even though these income items are not taxable, they **must** be included here to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c **13c**

14 Enter the amount from Form 1040A, line 22, or Form 1040, line 38 . . . . . **14**

15 **If you checked (in Part I):** **Enter:**
Box 1 or 2 . . . . . . $7,500
Box 3, 4, 5, 6, or 7 . . . $10,000
Box 8 or 9 . . . . . . $5,000
} **15**

16 Subtract line 15 from line 14. If zero or less, enter -0- **16**

17 Enter one-half of line 16 . . . . **17**

18 Add lines 13c and 17 . . . . **18**

19 Subtract line 18 from line 12. If zero or less, **stop;** you **cannot** take the credit. Otherwise, go to line 20 . . . . **19**

20 Multiply line 19 by 15% (.15). **20**

21 Tax liability limit. Enter the amount from the Credit Limit Worksheet in the instructions . **21**

22 **Credit for the elderly or the disabled.** Enter the **smaller** of line 20 or line 21. Also enter this amount on Form 1040A, line 30, or include on Form 1040, line 53 (check box **c** and enter "Sch R" on the line next to that box) **22**

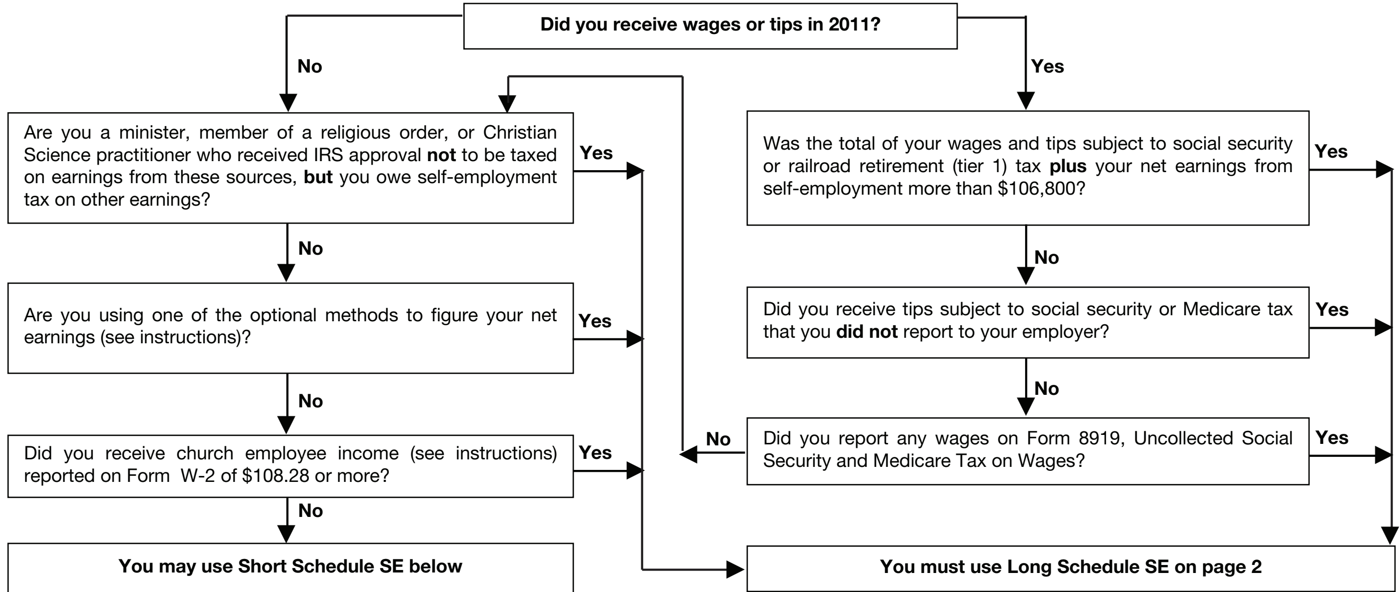
SCHEDULE SE (Form 1040)	**Self-Employment Tax**	OMB No. 1545-0074
Department of the Treasury Internal Revenue Service (99)	▶ Attach to Form 1040 or Form 1040NR. ▶ See separate instructions.	2011 Attachment Sequence No. 17

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ▶	

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A . . .	**1a**	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Y	**1b**	( )
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report . . .	**2**	
3	Combine lines 1a, 1b, and 2 . . .	**3**	
4	Multiply line 3 by 92.35% (.9235). If less than $400, you do not owe self-employment tax; **do not** file this schedule unless you have an amount on line 1b . . . ▶	**4**	
	Note. If line 4 is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.		
5	**Self-employment tax.** If the amount on line 4 is: • $106,800 or less, multiply line 4 by 13.3% (.133). Enter the result here and on **Form 1040, line 56,** or **Form 1040NR, line 54** • More than $106,800, multiply line 4 by 2.9% (.029). Then, add $11,107.20 to the result. Enter the total here and on **Form 1040, line 56,** or **Form 1040NR, line 54** . . .	**5**	
6	**Deduction for employer-equivalent portion of self-employment tax.** If the amount on line 5 is: • $14,204.40 or less, multiply line 5 by 57.51% (.5751) • More than $14,204.40, multiply line 5 by 50% (.50) and add $1,067 to the result. Enter the result here and on **Form 1040, line 27,** or **Form 1040NR, line 27** . . . **6**		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2011**

Name of person with **self-employment** income (as shown on Form 1040) | Social security number of person with **self-employment** income ▶

Section B—Long Schedule SE

Part I Self-Employment Tax

Note. If your only income subject to self-employment tax is **church employee income,** see instructions. Also see instructions for the definition of church employee income.

Line	Description			Box	Amount	
A	If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I . . . . ▶ ☐					
1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. **Note.** Skip lines 1a and 1b if you use the farm optional method (see instructions)			1a		
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Y			1b	(	)
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report. **Note.** Skip this line if you use the nonfarm optional method (see instructions) . . .			2		
3	Combine lines 1a, 1b, and 2 . . .			3		
4a	If line 3 is more than zero, multiply line 3 by 92.35% (.9235). Otherwise, enter amount from line 3			4a		
	Note. If line 4a is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.					
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here . .			4b		
c	Combine lines 4a and 4b. If less than $400, **stop**; you do not owe self-employment tax. **Exception.** If less than $400 and you had **church employee income,** enter -0- and continue ▶			4c		
5a	Enter your **church employee income** from Form W-2. See instructions for definition of church employee income . . .	5a				
b	Multiply line 5a by 92.35% (.9235). If less than $100, enter -0- . . .			5b		
6	Add lines 4c and 5b . . .			6		
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 4.2% portion of the 5.65% railroad retirement (tier 1) tax for 2011 . . .			7	106,800	00
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $106,800 or more, skip lines 8b through 10, and go to line 11	8a				
b	Unreported tips subject to social security tax (from Form 4137, line 10)	8b				
c	Wages subject to social security tax (from Form 8919, line 10)	8c				
d	Add lines 8a, 8b, and 8c . . .			8d		
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 . ▶			9		
10	Multiply the **smaller** of line 6 or line 9 by 10.4% (.104) . . .			10		
11	Multiply line 6 by 2.9% (.029) . . .			11		
12	**Self-employment tax.** Add lines 10 and 11. Enter here and on **Form 1040, line 56,** or **Form 1040NR, line 54**			12		
13	**Deduction for employer-equivalent portion of self-employment tax.** Add the two following amounts. • 59.6% (.596) of line 10. • One-half of line 11. Enter the result here and on **Form 1040, line 27,** or **Form 1040NR, line 27** . . .	13				

Part II Optional Methods To Figure Net Earnings (see instructions)

Farm Optional Method. You may use this method **only** if **(a)** your gross farm income[1] was not more than $6,720, **or (b)** your net farm profits[2] were less than $4,851.

Line	Description	Box	Amount	
14	Maximum income for optional methods . . .	14	4,480	00
15	Enter the **smaller** of: two-thirds (2/3) of gross farm income[1] (not less than zero) **or** $4,480. Also include this amount on line 4b above . . .	15		

Nonfarm Optional Method. You may use this method **only** if **(a)** your net nonfarm profits[3] were less than $4,851 and also less than 72.189% of your gross nonfarm income,[4] **and (b)** you had net earnings from self-employment of at least $400 in 2 of the prior 3 years. **Caution.** You may use this method no more than five times.

Line	Description	Box	Amount	
16	Subtract line 15 from line 14 . . .	16		
17	Enter the **smaller** of: two-thirds (2/3) of gross nonfarm income[4] (not less than zero) **or** the amount on line 16. Also include this amount on line 4b above . . .	17		

[1] From Sch. F, line 9, and Sch. K-1 (Form 1065), box 14, code B.

[2] From Sch. F, line 34, and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method.

[3] From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9, code J1.

[4] From Sch. C, line 7; Sch. C-EZ, line 1d; Sch. K-1 (Form 1065), box 14, code C; and Sch. K-1 (Form 1065-B), box 9, code J2.

Form **1040A** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return (99) 2011

IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

Your first name and initial	Last name	Your social security number
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/county	Foreign postal code

Filing status
Check only one box.

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

Exemptions

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

Boxes checked on 6a and 6b

c **Dependents:**

If more than six dependents, see instructions.

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

No. of children on 6c who:
- **lived with you**
- **did not live with you due to divorce or separation (see instructions)**

Dependents on 6c not entered above

d Total number of exemptions claimed.

Add numbers on lines above ▶

Income

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

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

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

7 Wages, salaries, tips, etc. Attach Form(s) W-2. 7
8a **Taxable** interest. Attach Schedule B if required. 8a
b **Tax-exempt** interest. **Do not** include on line 8a. 8b
9a Ordinary dividends. Attach Schedule B if required. 9a
b Qualified dividends (see instructions). 9b
10 Capital gain distributions (see instructions). 10
11a IRA distributions. 11a — 11b Taxable amount (see instructions). 11b
12a Pensions and annuities. 12a — 12b Taxable amount (see instructions). 12b
13 Unemployment compensation and Alaska Permanent Fund dividends. 13
14a Social security benefits. 14a — 14b Taxable amount (see instructions). 14b
15 Add lines 7 through 14b (far right column). This is your **total income.** ▶ 15

Adjusted gross income

16 Educator expenses (see instructions). 16
17 IRA deduction (see instructions). 17
18 Student loan interest deduction (see instructions). 18
19 Tuition and fees. Attach Form 8917. 19
20 Add lines 16 through 19. These are your **total adjustments.** 20
21 Subtract line 20 from line 15. This is your **adjusted gross income.** ▶ 21

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11327A Form **1040A** (2011)

Tax, credits, and payments

22 Enter the amount from line 21 (adjusted gross income). 22

23a Check if: ☐ **You** were born before January 2, 1947, ☐ Blind; ☐ **Spouse** was born before January 2, 1947, ☐ Blind } **Total boxes checked** ▶ 23a ☐

b If you are married filing separately and your spouse itemizes deductions, check here ▶ 23b ☐

Standard Deduction for—
- People who check any box on line 23a or 23b **or** who can be claimed as a dependent, see instructions.
- All others:

Single or Married filing separately, $5,800

Married filing jointly or Qualifying widow(er), $11,600

Head of household, $8,500

24 Enter your **standard deduction.** 24

25 Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-. 25

26 **Exemptions.** Multiply $3,700 by the number on line 6d. 26

27 Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your **taxable income.** ▶ 27

28 **Tax,** including any alternative minimum tax (see instructions). 28

29 Credit for child and dependent care expenses. Attach Form 2441. 29

30 Credit for the elderly or the disabled. Attach Schedule R. 30

31 Education credits from Form 8863, line 23. 31

32 Retirement savings contributions credit. Attach Form 8880. 32

33 Child tax credit (see instructions). 33

34 Add lines 29 through 33. These are your **total credits.** 34

35 Subtract line 34 from line 28. If line 34 is more than line 28, enter -0-. This is your **total tax.** 35

36 Federal income tax withheld from Forms W-2 and 1099. 36

37 2011 estimated tax payments and amount applied from 2010 return. 37

If you have a qualifying child, attach Schedule EIC.

38a **Earned income credit (EIC).** 38a

b Nontaxable combat pay election. 38b

39 Additional child tax credit. Attach Form 8812. 39

40 American opportunity credit from Form 8863, line 14. 40

41 Add lines 36, 37, 38a, 39, and 40. These are your **total payments.** ▶ 41

Refund

42 If line 41 is more than line 35, subtract line 35 from line 41. This is the amount you **overpaid.** 42

43a Amount of line 42 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐ 43a

Direct deposit? See instructions and fill in 43b, 43c, and 43d or Form 8888.

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

44 Amount of line 42 you want **applied to your 2012 estimated tax.** 44

Amount you owe

45 **Amount you owe.** Subtract line 41 from line 35. For details on how to pay, see instructions. ▶ 45

46 Estimated tax penalty (see instructions). 46

Third party designee

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

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

Sign here

Joint return? See page 13.

Keep a copy for your records.

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

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid preparer use only

Print/type preparer's name	Preparer's signature	Date	Check ▶ ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Form **1040A** (2011)

Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

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

OMB No. 1545-0074

2011

Attachment Sequence No. **129**

Your name	Occupation in which you incurred expenses	**Social security number**

Part I **Employee Business Expenses and Reimbursements**

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

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

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

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

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

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8		
Note: *If* ***both columns*** *of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	9		
10 Add the amounts on line 9 of both columns and enter the total here. **Also, enter the total on Schedule A (Form 1040), line 21** (or on **Schedule A (Form 1040NR), line 7**). (Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶		10	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11700N Form **2106** (2011)

Part II Vehicle Expenses

Section A—General Information (You must complete this section if you are claiming vehicle expenses.)		(a) Vehicle 1	(b) Vehicle 2
11 Enter the date the vehicle was placed in service	11	/ /	/ /
12 Total miles the vehicle was driven during 2011	12	miles	miles
13 Business miles included on line 12	13	miles	miles
14 Percent of business use. Divide line 13 by line 12	14	%	%
15 Average daily roundtrip commuting distance	15	miles	miles
16 Commuting miles included on line 12	16	miles	miles
17 Other miles. Add lines 13 and 16 and subtract the total from line 12	17	miles	miles

18 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

19 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

20 Do you have evidence to support your deduction? ☐ Yes ☐ No

21 If "Yes," is the evidence written? ☐ Yes ☐ No

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

22 Multiply line 13 by 51¢ (.51) for miles driven **before** July 1, 2011, and by 55.5¢ (.555) for miles driven **after** June 30, 2011. Add the amounts, then enter the result here and on line 1. | 22 |

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

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

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

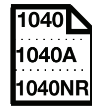
Form **2441**

Department of the Treasury
Internal Revenue Service (99)

Child and Dependent Care Expenses

▶ Attach to Form 1040, Form 1040A, or Form 1040NR.

▶ See separate instructions.



OMB No. 1545-0074

2011

Attachment Sequence No. 21

Name(s) shown on return | Your social security number

Part I **Persons or Organizations Who Provided the Care—**You **must** complete this part.
(If you have more than two care providers, see the instructions.)

1 (a) Care provider's name	(b) Address (number, street, apt. no., city, state, and ZIP code)	(c) Identifying number (SSN or EIN)	(d) Amount paid (see instructions)

Did you receive **dependent care benefits?**
No ⟶ Complete only Part II below.
Yes ⟶ Complete Part III on the back next.

Caution. If the care was provided in your home, you may owe employment taxes. If you do, you cannot file Form 1040A. For details, see the instructions for Form 1040, line 59a, or Form 1040NR, line 58a.

Part II **Credit for Child and Dependent Care Expenses**

2 Information about your **qualifying person(s)**. If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name — First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2011 for the person listed in column (a)

3 Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 31 . . . . . **3**

4 Enter your **earned income**. See instructions **4**

5 If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others**, enter the amount from line 4 . . . . **5**

6 Enter the **smallest** of line 3, 4, or 5 . . . . . **6**

7 Enter the amount from Form 1040, line 38; Form 1040A, line 22; or Form 1040NR, line 37. . . . . **7**

8 Enter on line 8 the decimal amount shown below that applies to the amount on line 7

If line 7 is: Over	But not over	Decimal amount is	If line 7 is: Over	But not over	Decimal amount is
$0	15,000	.35	$29,000	31,000	.27
15,000	17,000	.34	31,000	33,000	.26
17,000	19,000	.33	33,000	35,000	.25
19,000	21,000	.32	35,000	37,000	.24
21,000	23,000	.31	37,000	39,000	.23
23,000	25,000	.30	39,000	41,000	.22
25,000	27,000	.29	41,000	43,000	.21
27,000	29,000	.28	43,000	No limit	.20

8 X.

9 Multiply line 6 by the decimal amount on line 8. If you paid 2010 expenses in 2011, see the instructions **9**

10 Tax liability limit. Enter the amount from the Credit Limit Worksheet in the instructions. **10**

11 **Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 10 here and on Form 1040, line 48; Form 1040A, line 29; or Form 1040NR, line 46 . . . . **11**

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11862M Form **2441** (2011)

Part III Dependent Care Benefits

12	Enter the total amount of **dependent care benefits** you received in 2011. Amounts you received as an employee should be shown in box 10 of your Form(s) W-2. **Do not** include amounts reported as wages in box 1 of Form(s) W-2. If you were self-employed or a partner, include amounts you received under a dependent care assistance program from your sole proprietorship or partnership	12	
13	Enter the amount, if any, you carried over from 2010 and used in 2011 during the grace period. See instructions	13	
14	Enter the amount, if any, you forfeited or carried forward to 2012. See instructions	14	( )
15	Combine lines 12 through 14. See instructions	15	
16	Enter the total amount of **qualified expenses** incurred in 2011 for the care of the **qualifying person(s)** . . . 16		
17	Enter the **smaller** of line 15 or 16 . . . 17		
18	Enter your **earned income.** See instructions . . . 18		
19	Enter the amount shown below that applies to you. • If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions for line 5). • If married filing separately, see instructions. • All others, enter the amount from line 18. . . . 19		
20	Enter the **smallest** of line 17, 18, or 19 . . . 20		
21	Enter $5,000 ($2,500 if married filing separately **and** you were required to enter your spouse's earned income on line 19) . . . 21		
22	Is any amount on line 12 from your sole proprietorship or partnership? (Form 1040A filers go to line 25.) ☐ **No.** Enter -0-. ☐ **Yes.** Enter the amount here	22	
23	Subtract line 22 from line 15 . . . 23		
24	**Deductible benefits.** Enter the **smallest** of line 20, 21, or 22. Also, include this amount on the appropriate line(s) of your return. See instructions	24	
25	**Excluded benefits. Form 1040 and 1040NR filers:** If you checked "No" on line 22, enter the smaller of line 20 or 21. Otherwise, subtract line 24 from the smaller of line 20 or line 21. If zero or less, enter -0-. **Form 1040A filers:** Enter the **smaller** of line 20 or line 21	25	
26	**Taxable benefits. Form 1040 and 1040NR filers:** Subtract line 25 from line 23. If zero or less, enter -0-. Also, include this amount on Form 1040, line 7; or Form 1040NR, line 8. On the dotted line next to Form 1040, line 7; or Form 1040NR, line 8, enter "DCB." **Form 1040A filers:** Subtract line 25 from line 15. Also, include this amount on Form 1040A, line 7. In the space to the left of line 7, enter "DCB"	26	

To claim the child and dependent care credit, complete lines 27 through 31 below.

27	Enter $3,000 ($6,000 if two or more qualifying persons)	27	
28	**Form 1040 and 1040NR filers:** Add lines 24 and 25. **Form 1040A filers:** Enter the amount from line 25	28	
29	Subtract line 28 from line 27. If zero or less, **stop.** You cannot take the credit. **Exception.** If you paid 2010 expenses in 2011, see the instructions for line 9	29	
30	Complete line 2 on the front of this form. **Do not** include in column (c) any benefits shown on line 28 above. Then, add the amounts in column (c) and enter the total here.	30	
31	Enter the **smaller** of line 29 or 30. Also, enter this amount on line 3 on the front of this form and complete lines 4 through 11	31	

Glossary

Accrual – Recognizing and reporting items in a time period prior to the period of receipt or disbursement, when all events have occurred to fix the right to receipt of the income or to establish the fact of liability.

Adjusted Gross Income (AGI) – All taxable income of an individual filer from whatever sources derived less certain deductions allowed as defined in IRC Sec. 62. AGI is used as a threshold in individual income taxation to calculate eligibility (or phase-out of eligibility) for many deductions, credits, or taxability of specific types of income.

Alternative Minimum Tax (AMT) – A tax imposed as a backup to regular tax originally intended to ensure that higher income taxpayers paid their fair share of tax. AMT is separate from, but parallel to, regular tax, and a taxpayer pays the greater of regular tax or AMT.

Alternative Minimum Taxable Income (AMTI) – Taxable income plus or minus alternative minimum tax adjustments, plus alternative minimum tax preferences. It is used to determine AMT.

Annuity – A contract issued by an insurance company under which, for a fixed amount of investment, the investor will receive regular payments in the future.

Compensation – Income received as payment for services rendered.

Deferral – Recognizing and reporting items in a time period subsequent to the period of realization.

Earned Income Credit (EIC) – Calculated by multiplying earned income by a credit percentage. A taxpayer's number of children affects the calculation, and the credit is subject to income phase-out ranges so as to focus its benefits on low income individuals.

Individual Retirement Account (IRA) – A retirement account set up by an individual as a means of setting money aside for his or her retirement years.

Passive Activity – Passive activity is (1) any trade or business or income-producing activity in which the taxpayer does not materially participate and (2) all rental activities (subject to certain exceptions).

Principal Residence – A taxpayer's primary residence that is eligible for gain exclusion if (1) owned for at least two of the previous five years and (2) occupied for at least two of the previous five years, based on the date of sale.

Qualified Plan – Pension, profit sharing or stock bonus trust plan that meets certain requirements pertaining to discrimination in favor of highly compensated employees.

Self-employment Tax (SE Tax) – A tax imposed on individuals with self-employment income of $400 or more to provide social security and Medicare benefits to those individuals.

Simple Trust – A trust which, generally, must distribute all income received during the tax year.

Taxable Income – AGI less the greater of the standard deduction or total itemized deductions, less personal and dependency exemptions.

Transfer Tax – Tax imposed on transfers of property by gift or death of the transferor. It is composed of the following: (1) estate transfer tax, (2) gift transfer tax, and (3) generation skipping transfer (GST) tax.

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Testing Instructions for Examination for CPE Credit

1040 Income Tax Preparation (DT1TG11)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.
2. **ONLINE GRADING**. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam by selecting Gear Up/Quickfinder in the drop-down box under Brand. Payment of $89 for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.
3. **PRINT GRADING**. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.
4. Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

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   DT1TG11 Self-study CPE
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   Chicago, IL 60694-6700
5. You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.
6. Please allow a minimum of three weeks for grading.
7. **Note:** The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.
8. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
9. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $89.
10. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2012**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for **an additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
11. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.
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To enhance your learning experience, examination questions are located immediately following each chapter. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each chapter, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging on to the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-Study Course Evaluation Form** are located on the following pages.

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Chapter 2 33

Chapter 3 45

Chapter 4 65

Chapter 5 103

Chapter 6 125

Chapter 7 157

Chapter 8 167

Chapter 9 179

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Chapter 11 203

Chapter 12 219

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

1040 Income Tax Preparation (DT1TG11)

Price – $89

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	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

Course Title: 1040 Income Tax Preparation Course Acronym: DT1TG11

Your Name (optional): ______________________ Date: ______________

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓.

	a	b	c	d
41.	○	○	○	○
42.	○	○	○	○
43.	○	○	○	○
44.	○	○	○	○
45.	○	○	○	○
46.	○	○	○	○
47.	○	○	○	○
48.	○	○	○	○
49.	○	○	○	○
50.	○	○	○	○

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Expiration Date: December 31, 2012

Self-Study Course Evaluation

Please print legibly. Thank you for your feedback!

Course Title: 1040 Income Tax Preparation Course Acronym: DT1TG11

Your Name (optional): ________________ Date: ________________

Email: ________________

Please indicate your answers by filling in the appropriate circle as shown:

Fill in like this ● not like this ╲ . ╳ √

Satisfaction Level:	**Low (1) . . . to . . . High (10)**									
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
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8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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2. What did you find **least** helpful?
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