TDBT09

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

1040 Deskbook

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Interactive Self-study CPE

Companion to PPC's 1040 Deskbook

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INTRODUCTION

Companion to PPC's 1040 Deskbook consists of three interactive self-study CPE courses. These are companion courses to *PPC's 1040 Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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Each course is divided into lessons. Each lesson addresses an aspect of Form 1040. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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COMPANION TO PPC'S 1040 DESKBOOK

COURSE 1

Form 1040 Supplemental Schedules C, F, & E (TDBTG091)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to Schedules commonly attached to Form 1040. The first lesson covers topics unique to sole proprietorships, including the confusing issue of the home office. The second lesson covers Farm Income and Expense including the treatment of co-op patronage dividends and prepaid farm expenses. Uniform Capitalization rules are also discussed. The last lesson discusses rental property. Topics include conversion of a residence to rental property and property rented to related parties.

PUBLICATION/REVISION DATE: November 2009

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation.

CPE CREDIT: 7 QAS Hours, 7 Registry Hours
CTEC HOURS: 7 Federal, 0 California

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 course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2010**

KNOWLEDGE LEVEL: Basic

LEARNING OBJECTIVES:

Lesson 1—Sole Proprietorships (Schedule C)

Completion of this lesson will enable you to:

- Distinguish between an active trade or business and a hobby.
- Describe the tax treatment of costs related to oil and gas working interests.
- Compute the deductions for a home office.
- Differentiate between deductible and capitalized start-up costs.
- Compute the gain or loss on the disposal of a sole proprietorship.

Lesson 2—Farm Income and Expenses (Schedule F)

Completion of this lesson will enable you to:

- Determine the tax treatment of cooperative patronage distributions and CCC loans.
- Describe the rules for prepaid farming expenses, the deferral of certain farming income and depreciation methods for farm property.

- Define uniform capitalization rules and commodity hedging transactions.
- Define crop-share rental reporting.

Lesson 3—Rental Property (Schedule E)

Completion of this lesson will enable you to:

- Allocate income and expense items for rental property also used as a personal residence.
- Describe the treatment of property converted from a residence to a rental unit and related parties in a property rental.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
TDBTG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

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Lesson 1: Sole Proprietorships (Schedule C)

INTRODUCTION

Taxpayers who are self-employed in a nonfarm business report their business transactions on Schedule C (Profit or Loss From Business) or Schedule C-EZ (Net Profit From Business). The net profit or loss from Schedule C or C-EZ is reported on page 1 of Form 1040. A separate Schedule C must be prepared for each business operated by the sole proprietor. Taxpayers operating multiple businesses as sole proprietorships cannot use Schedule C-EZ.

For simplicity, this lesson refers to Schedule C as the place to report business-related income and expenses. Where appropriate, however, Schedule C-EZ should be used when there is $5,000 or less of business expenses and the other requirements listed on Part 1, Schedule C-EZ, are met.

Other tax matters relevant to sole proprietors include:

1. Deductions for contributions to Keogh, SEP, or SIMPLE retirement plans.
2. Self-employed taxpayers' deduction for health insurance premiums.
3. Deductions for contributions to medical and health savings accounts (MSAs & HSAs).
4. Deductions for travel and entertainment expenses.
5. Tax accounting methods and inventory rules.
6. Depreciation of business property.
7. Deductions for the business use of vehicles and other listed property owned or leased.
8. Sale or abandonment of business property.
9. Allocating deductions that are partly related to the sole proprietorship and partly personal or employee business expenses.
10. Self-employment tax and the deduction allowed for half the tax.
11. Estimated tax payment safe harbor rules.
12. Earned Income Credit calculations.

These matters are beyond the scope of this course. More information on these topics can be found in *PPC's 1040 Deskbook*.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:

- Distinguish between an active trade or business and a hobby.
- Describe the tax treatment of costs related to oil and gas working interests.
- Compute the deductions for a home office.
- Differentiate between deductible and capitalized start-up costs.
- Compute the gain or loss on the disposal of a sole proprietorship.

Difference Between an Active Trade or Business and a Hobby

Determining if an individual is engaged in carrying on a trade or business has implications beyond whether a net loss will be allowed to offset other income, although this income offset is the most obvious benefit for many

taxpayers. Items affected by this determination include (but are not limited to):

1. Self-employment (SE) tax and, ultimately, social security benefits.
2. IRA, Keogh, SEP, or SIMPLE retirement plan contributions.
3. Deductions for health insurance premiums and contributions to medical savings accounts (MSAs).
4. Home office deductions.
5. Limited expensing (Section 179) deductions.
6. Amortization of start-up expenditures.
7. Character of gain or loss upon disposition of assets.
8. Net operating loss (NOL) carryovers and carrybacks.
9. AGI-sensitive deductions including rental losses, medical expenses, casualty losses, etc.
10. AGI-sensitive credits.
11. Deferral of estate tax and the special-use valuation of assets.

Therefore, it is no surprise that this issue has historically been one of the most frequently litigated and controversial areas of individual income tax law.

Distinguishing between a Hobby and an Active Trade or Business

The Internal Revenue Code backs into the rules governing activities not engaged in for profit (commonly referred to as hobbies) by including all activities of the taxpayer other than those for which deductions are allowable under IRC Sec. 162 (expenses of carrying on a trade or business) or 212 (expenses incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income).

Determining if an activity is engaged in for profit is based on the facts and circumstances of each case. However, Reg. 1.183-2(b) provides factors to consider. These factors are frequently applied in relevant case law. Although certain activities are more susceptible to the hobby loss taint (e.g., weekend farmer/rancher; auto racing; certain pyramid marketing schemes; and horse or dog racing, breeding, or showing), no activities are immune. For example, in *Ranciato*, the Tax Court held that a retail pet store failed to qualify as a for-profit activity based on an analysis of the factors outlined in Reg. 1.183-2(b). But see *Rinehart* for an example of a horse breeding activity that was held by the Tax Court to be a for-profit venture and *Morrissey* for an example where auto racing was held to be a for-profit venture. The presence of a profit intent in earlier years is not determinative for the tax year in question. In any case, the taxpayer must be conducting the activity with the actual and honest *intent* to make a profit in order to escape the hobby loss taint. While maintaining financial records can be an indication of a taxpayer's profit motive, the existence of financial records alone may not be enough to demonstrate that an activity is not a hobby. Obtaining professional advice about how to make the activity profitable is another indicator of a profit motive, but failure to follow the advice can demonstrate the lack of such a motive. *Mitchell and Keating* have detailed discussions of the factors outlined in Reg. 1.183-2(b). IRS Fact Sheet "Is Your Hobby a For-Profit Endeavor?" also gives general discussion and guidelines for this topic. The Audit Techniques Guide (ATG) located at **http://www.irs.gov/businesses/small/article/0,,id=208400,00.html** provides a detailed look at issues the IRS considers when auditing for hobby activities.

Reporting Hobby Income and Expenses When Activity Is Not Deemed to Be a Trade or Business

For an activity deemed to be a hobby, expenses are allowed to the extent of income produced by the activity, subject to the following ordering system:

1. Expenses incurred that are otherwise deductible without regard to the profit motive (e.g., real estate taxes).

2. Expenses incurred that would be deductible if the activity was engaged in for profit, but which do not result in a basis adjustment. These include normal trade or business expenses (such as advertising, insurance, and utilities) other than depreciation or amortization.

3. Expenses meeting the requirements in category 2, which do result in a basis adjustment (e.g., depreciation expenses).

Expenses in category 2 or 3 are allowed only to the extent of the excess, if any, of income from the activity over allowable expenses from category 1. (See Example 1A-1.) Certain types of expenses may fall in more than one category. Expenses that fall in category 2 or 3 are deductible only as miscellaneous itemized deductions and then only to the extent of any remaining hobby income. Since these deductions are subject to the 2% of AGI limitation, a taxpayer may end up with net taxable income from a hobby activity even though the allowable expenses equal the income from the activity.

Example 1A-1 Hobby loss limitations.

In the current year, Bobby Canine begins breeding and selling Labrador retrievers and derives $2,200 of income from the activity. He does not expect to report a profit for three out of five years (see safe harbor rule later in this lesson) nor can he support that the activity is for-profit based on the facts and circumstances. Thus, the activity is deemed to be a hobby. Bobby's AGI (before the dog breeding activity) for the current year is $130,000, and he has $1,850 of other miscellaneous itemized deductions subject to the 2% of AGI floor.

His hobby expenses (food, veterinarian bills, etc.) total $2,300. These are deductible only to the extent of hobby income ($2,200) and only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2% of AGI. The net amount of miscellaneous itemized deductions is calculated as follows:

Miscellaneous itemized deductions from hobby (limited to hobby income)	$ 2,200
Other miscellaneous itemized deductions	1,850
Total miscellaneous itemized deductions	4,050
2% of AGI [2% × $132,200 ($130,000 plus $2,200 hobby income)]	(2,644)
Net miscellaneous itemized deductions allowed	$ 1,406

Thus, Bobby is allowed miscellaneous itemized deductions, after applying the 2% floor, of $1,406. Instead of reducing hobby income to zero, the limitation on deductible miscellaneous deductions has caused Bobby to have net taxable income from his hobby of $794 ($2,200 of income reportable on the "other income" line on page 1 of Form 1040 less $1,406 of hobby expenses deductible on Schedule A as miscellaneous itemized deductions). The 2% of AGI floor has penalized Bobby because his hobby expenses were not, in fact, deductible to the extent of hobby income. There is no provision for the carryover of disallowed hobby expenses. Bobby did not receive any deduction for depreciation on his kennel because all hobby income was offset with other types of expenses. Therefore, no reduction to the adjusted basis of his kennel is required.

Variation: Assume that Bobby had $2,850 in other miscellaneous itemized deductions, rather than $1,850. The net amount of miscellaneous itemized deductions is calculated as follows:

Miscellaneous itemized deductions from hobby (limited to hobby income)	$ 2,200
Other miscellaneous itemized deductions	2,850
Total miscellaneous itemized deductions	5,050
2% of AGI [2% × $132,200 ($130,000 plus $2,200 hobby income)]	(2,644)
Net miscellaneous itemized deductions allowed	$ 2,406

In this case, Bobby's increase in taxable income due to the hobby loss is only $44 (the increased AGI limitation of 2% × $2,200) since he was already able to use a portion of his miscellaneous itemized deductions.

Safe Harbor Rule Helps Eliminate Uncertainty between a Hobby and an Active Trade or Business

A statutory safe harbor is provided that, if met, causes a presumption that an activity is a for-profit endeavor. If the safe harbor is not met, the taxpayer must establish a profit motive using the subjective factors mentioned in the regulations. To meet the safe harbor, an activity must generate a profit in at least three of the five years (two of seven years for activities involving horse racing, breeding, training, or showing) ending with the tax year in question. If the safe harbor is met, the burden of proof for lack of profit motive is shifted to the IRS. The IRS can still rebut the profit motive presumption by proving that the activity is not engaged in for profit (e.g., by showing that the profitable years generated immaterial profits while the unprofitable years generated large losses).

Applying the Safe Harbor Rule. The safe harbor rule applies only for the third (or second) profitable year and all subsequent years within a five-year (or seven-year) safe harbor period that begins with the first profitable year.

Example 1A-2 Applying the safe harbor rule.

Tim Jones begins a new activity in Year 1 and incurs losses from that activity in Years 1 and 3. The activity is profitable in Years 2, 4, 5, and 6. Assuming the five-year test applies to the activity, the five-year safe harbor period begins with Year 2 (because it is the first profitable year) and covers Years 2–6. The safe harbor rule applies only for Years 5 and 6 (because Year 5 is the third profitable year after the start of the five-year period) but does not apply for Years 1–4.

Thus, the IRS can assert that the losses incurred in Years 1 and 3 must be reported under the hobby loss rules (unless Tim can prove otherwise under the subjective factors in the regulations. Furthermore, the IRS presumably can assert that profitable Years 2 and 4 must also be reported under the hobby loss rules. As previously explained, such reporting may not result in a total offset of income with deductions because the hobby income is reported on page 1 of Form 1040 and the allowable hobby deductions are reported on Schedule A of Form 1040 as itemized deductions subject to the 2% of AGI limitation. Additionally, if there is AMT exposure the miscellaneous deductions may be disallowed.

Because Tim cannot rely on the safe harbor rule before Year 5, he will have to rely on facts and circumstances to establish a profit motive for Years 1–4. Alternatively, Tim can make an election under IRC Sec. 183(e) to postpone the safe harbor determination (see discussion later in this lesson).

Example 1A-3 Three profit years must precede safe harbor loss year.

At the end of Year 3 in Example 1A-2, Tim could not rely on the safe harbor (presuming that Year 3 is a profit-motive year) and report income and deductions for Year 3 on his Schedule C. Even if he knew what the future outcome would be for Years 4–6, future years have no bearing on the ability to use the safe harbor for Year 3 under the general presumptive rule of IRC Sec. 183(d). (Also, three profitable years had not yet occurred at that time.) In fact, although two of the next three years did produce profits (thus producing an applicable safe harbor five-year period containing three profitable years), the application of the safe harbor does not apply to a loss year until Year 5.

Electing to Postpone the Safe Harbor Profit Presumption. A taxpayer may elect to delay a determination as to whether the safe harbor applies until the close of the fourth (or sixth, in the case of horse racing, breeding, training, or showing) tax year after the tax year in which the taxpayer first engages in the activity.

To make a valid election, the taxpayer must file Form 5213 (Election To Postpone Determination as to Whether the Presumption Applies That an Activity is Engaged in for Profit). The election Form 5213 is filed, separate from any other form or return, with the IRS Service Center where the taxpayer files his or her tax return. The election automatically extends the statute of limitations for all years in the postponement period until two years after the due date (without extensions) of the return for the last tax year in the five- (or seven-) year presumption period. However, the statute of limitations is extended only for items related to the activity and other items on the return that would be directly affected by the activity's deductions.

Oil and Gas Working Interests

General Rules

A working interest in an oil and gas property represents a lease agreement between the landowner and the working interest owner. In consideration for the landowner's agreement to lease the land and assign the rights to the minerals underneath, the working interest owner agrees that a portion, usually one-sixth or one-eighth, of all minerals produced belongs to the landowner. The landowner receives this portion (referred to as a royalty) free of any charges or costs other than state severance (production) taxes.

The owner of the working interest (sometimes referred to as an operating interest) in an oil and gas property assumes the burden of developing and operating the property. The working interest owner bears all costs involved in finding oil or gas and, if exploration is successful, the expenses incurred in lifting the minerals from the reservoir.

For the individual taxpayer, income and expenses from oil and gas working interests normally are reported on Schedule C with a supporting schedule reporting income and expenses on a property-by-property basis. If the interest is owned through a partnership or S corporation, however, the taxpayer should receive a Schedule K-1 detailing the items to be reported and where they are reported on his return. The royalty interest (RI) owner (e.g., landowner) reports the royalty income and expenses (e.g., severance taxes, depletion) on Part I of Schedule E. Finally, Form 8903 may need to be completed for the Domestic Producer Activities Deduction.

In Rev. Rul. 58-166, the IRS held that income received from a working interest is included in determining the taxpayer's "net earnings from self-employment" for the self-employment tax.

Prepaid Drilling Costs

During the preproduction (drilling) stage of the well, each working interest owner receives monthly invoices from the operator for their share of expenses. Many times, however, they prepay their share of the total estimated expenses in a lump sum before the well is drilled. When the prepayment is in the nature of a deposit (and the working interest owner might receive a refund after the drilling is complete), the Tax Court held that a cash-basis taxpayer cannot deduct the payment until actual expenses have been incurred by the drilling contractor. However, when nonrefundable prepayments are made under a turnkey contract, a cash-basis working interest owner is allowed a deduction in the year of payment for intangible drilling costs (discussed below) that are otherwise deductible. (With a turnkey contract, the drilling contractor agrees to supply everything and do all the work necessary to complete the well, place it in production, and turn it over ready to turn the key and start the oil flowing into the tanks.)

Any amounts paid for equipment or leasehold costs (LHCs), whether prepaid or otherwise, must be capitalized and recovered through depreciation (for the equipment) and depletion (for the leasehold). Depreciation and depletion are discussed later in this lesson.

Intangible Drilling Costs

Frequently, the largest single cost incurred by a working interest owner is the intangible drilling costs (IDC). The regulations define *IDC* as any cost incurred that in itself has no salvage value and is incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. These costs include wages, fuel, repairs, hauling, and supplies. In the first year IDC is incurred, the taxpayer may elect to currently deduct IDC. If the election is made, the taxpayer generally must deduct IDC in all subsequent years as it is paid or incurred for all properties. However, he or she can still make an annual election under IRC Sec. 59(e) to capitalize and amortize some or all of the IDC incurred that year over 60 months. If the Section 263(c) election is not made, IDC is capitalized and recovered through cost depletion or depreciation if the cost represents physical property.

A taxpayer who does not elect to expense IDC under IRC Sec. 263(c) may still elect to expense IDC on nonproductive wells (i.e., dry holes). The deduction for the costs of the nonproductive wells is allowable only in the year the wells are completed as dry holes. Even when some costs were incurred in one year and the outcome of the well is known by the time that year's tax return is filed, the costs may not be deducted until the year the well is completed.

Depreciation

A working interest owner's share of lease and well equipment costs is normally subject to capitalization and depreciation. However, during the drilling phase of the well, costs without any salvage value qualify as IDC and, thus, are not considered depreciable property. For many working interest owners, the majority of their depreciable costs will be incurred when a well is determined to be a producing property and pumping and storage equipment is placed in service at the well site. The operator of the well (usually *not* the working interest owner) determines the character of expenditures as either IDC or capitalizable lease and well equipment.

Assets used in drilling oil and gas wells (e.g., drilling rigs) are generally depreciated using a five-year MACRS recovery period. Assets used during the production phase and during operation, such as gathering pipelines, pumps, and related storage facilities, are depreciated using a seven-year MACRS recovery period. Rather than depreciate the property, however, taxpayers can elect to expense such costs under IRC Sec. 179, provided the other Section 179 conditions are met.

Depletion

The working interest owner is entitled to a deduction for the greater of cost depletion or allowable percentage depletion (sometimes referred to as statutory depletion). Cost depletion is based on the leasehold cost (LHC) of the property and is calculated using the mineral reserves (obtained from engineering reports) and the number of units sold for the year. For cash-basis taxpayers, the number of units sold means units for which payment was actually received within the tax year. Cost depletion is similar to depreciation determined on a units-of-production method.

Percentage depletion, on the other hand, is based on a percentage of gross receipts from the property. The rate is generally 15%, except a higher rate may be allowed for marginal production properties. (See discussion at the end of this lesson.) Independent producers (generally working interest owners who are not retailers or refiners) with less than 1,000 barrels of daily production qualify for percentage depletion. This includes most individuals. RI owners are also eligible for percentage depletion. Percentage depletion is limited to the net income from the property before deducting any depletion, hence the necessity of reporting income and expenses on a property-by-property basis in a supporting schedule to Schedule C (but see later discussion for an exception for marginal production property). Furthermore, a taxpayer's total percentage depletion deduction for the year from all oil and gas properties cannot exceed 65% of taxable income, computed without deducting percentage depletion, the domestic producer activities deduction, NOL carrybacks, and capital loss carrybacks (if a corporation). Deductions limited by this 65% limitation may be carried over to succeeding tax years. Examples 1B-1 and 1B-2 detail the calculation of percentage depletion and these limitations.

Example 1B-1 Computing percentage depletion.

Tyler Hunt invested in oil and gas properties for the first time on March 15, 2009. He owns a working interest in three producing wells that were all drilled during 2009 after Tyler acquired an interest in the properties. In addition, Tyler invested in three additional drilling projects that were determined to be dry holes and abandoned before the end of the year.

At year-end, Tyler received a separate Form 1099-MISC for each of the three producing properties. In the 1099-MISC box labeled "Nonemployee Compensation," the well operators listed the gross payments (before deducting severance tax) made to him for each well. Tyler saved all the stubs ("run tickets") from the revenue checks he received. The run tickets indicate gross revenue, severance tax expense, and barrels (oil) or MCF (thousand cubic feet—gas) produced by the well.

Tyler's other income is $94,000 in wages and $500 of interest income. His allowable itemized deductions total $24,000. He is married and has three children. The following chart details his oil and gas business interests:

	Wells					
	Deacon #1	**Deacon #2**	**Bentley #1**	**Rowe #1**	**Rowe #2**	**Rowe #3**
Dry Hole?	No	No	No	Yes	Yes	Yes
Tyler's share of:						
1. LHCs	$ 1,000	$ 1,000	$ 750	$ 850	$ 850	$ 850
2. IDC	9,000	8,500	9,200	6,700	9,100	6,200
3. Equipment	1,500	1,500	1,200	—	—	—
4. Lease operating expense (LOE)	2,200	3,000	1,800	—	—	—
5. Depreciation	179	179	143	—	—	—
6. Gross revenue	18,500	4,600	12,150	—	—	—
7. Severance tax	1,203	267	790	—	—	—

To document compliance with the various percentage depletion limitations, Reg. 1.613-6 requires the taxpayer to include in the return a schedule showing the data needed to determine taxable income from the property before the depletion deduction.

Example 1B-2 65% of taxable income limit for depletion.

Assume the same facts as in Example 1B-1. Tyler has no NOL carrybacks or Section 199 deduction. Tyler's overall limit for deducting percentage depletion is calculated as follows:

Wages	$ 94,000
Interest income	500
Tentative profit or loss from Schedule C line 29	(28,853)
Itemized deductions	(24,000)
Exemptions (5 × $3,650)	(18,250)
Taxable income before the 65% limitation calculation	23,397
Add back percentage (but not cost) depletion tentatively allowed per oil and gas depletion schedule maintained by Tyler	2,992
Adjusted taxable income	26,389
Percentage limitation	× 65%
Percentage depletion limit	$ 17,153

Tyler's percentage depletion deduction of $2,992 is fully allowed on his 2009 return.

Marginal Production Property. The percentage depletion rate for marginal production property is increased by 1% (to a maximum rate of 25%) for each whole dollar that the average crude oil price falls below $20. Marginal production includes oil and gas produced from stripper well property (property whose average daily production divided by the number of wells on the property is 15 barrels or less) or domestic property whose production is substantially all heavy oil (domestic crude oil with a weighted average gravity of 20 degrees API or less). The increased rate is applied in the year following the year the average price falls below $20. The 2009 depletion rate for marginal production property is 15%.

SELF-STUDY QUIZ

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

1. Mary shows her dog, Princess Pea, on the weekends at various competitions. Princess Pea won several competitions during 2009, earning Mary $5,000. Mary's expenses to attend these competitions totaled $7,500. Realizing she was spending more to attend these competitions than she was earning, she consulted a financial planner, who gave her just the advice she needed to be successful. However, at the start of the 2010 dog show season, she decided she would not follow the financial planner's advice. Based on the facts given, select the answer choice that contains the type of activity Mary is engaged in and the reason why it would be considered that particular type of activity.

   a. For-profit venture; she earned money.

   b. For-profit venture; she contacted a financial planner to improve profit.

   c. Hobby; she did not follow the financial planner's advice in order to improve profit.

   d. Hobby; showing dogs is always considered a hobby.

2. When claiming a hobby deduction, which of the following would be considered a category 1 expense?

   a. Real estate taxes.

   b. Advertising expense.

   c. Insurance expense.

   d. Depreciation expense.

Use the following information for questions 3 and 4

John incurred the following income and expenses related to his hobby activity:

Advertising expense	$ 800	Income	$2,100
Insurance expense	$1,200		
Depreciation expense	$ 350		
Total expenses	$2,350		

3. Assuming John's AGI, before the hobby activity, is $75,000 for 2009, what is John's net miscellaneous itemized deduction?

   a. $558.

   b. $1,542.

   c. $2,100.

   d. $2,350.

4. Assuming John's AGI, before the hobby activity, is $140,000 for 2009, and he has $2,600 of other miscellaneous itemized deductions subject to the 2% of AGI floor, John's increase in taxable income due to the hobby loss is:

   a. $0.

   b. $42.

   c. $1,542.

   d. $3,158.

5. Jason begins a new activity in 2007 in which he incurred a loss. He also incurred a loss in 2010. His activity is profitable in 2008, 2009, 2011, and 2012. Assuming the five-year test applies to the activity, the safe harbor rule applies only to:

   a. 2008.

   b. 2011.

   c. 2011 and 2012.

   d. 2008, 2009, and 2011.

6. What form must a taxpayer file to delay the determination as to whether the safe harbor profit presumption rules apply until the close of the fourth tax year after the tax year in which the taxpayer first engages in the activity?

   a. Form 2106.

   b. Form 5213.

   c. Form 8829.

   d. Form 8903.

7. Greg owns a working interest in several producing oil wells. Greg's adjusted taxable income for 2008 is $42,000. What is Greg's percentage depletion limit?

   a. $6,300.

   b. $14,700.

   c. $27,300.

   d. $42,000.

8. Allyson recently signed a lease agreement authorizing a gas well drilling company to drill a well on her 100 acres in rural America. The lease indicates she will be paid one-sixth of all gas produced by the well. The lease also states Allyson will not be responsible for any costs or charges for bringing the gas to the surface. Which of the following terms best describes the type of interest Allyson has in the gas well?

   a. Working interest.

   b. Royalty interest.

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.)**

1. Mary shows her dog, Princess Pea, on the weekends at various competitions. Princess Pea won several competitions during 2009, earning Mary $5,000. Mary's expenses to attend these competitions totaled $7,500. Realizing she was spending more to attend these competitions than she was earning, she consulted a financial planner, who gave her just the advice she needed to be successful. However, at the start of the 2010 dog show season, she decided she would not follow the financial planner's advice. Based on the facts given, select the answer choice that contains the type of activity Mary is engaged in and the reason why it would be considered that particular type of activity. **(Page 3)**

   a. For-profit venture; she earned money. [This answer is incorrect. While Mary did earn a minimal amount of money, her expenses exceeded her earnings. Based on the facts, she had no intent to make a profit on the showing of her dog.]

   b. For-profit venture; she contacted a financial planner in order to improve profit. [This answer is incorrect. Contacting a financial planner usually indicates a profit motive; however, Mary had decided not to follow the financial planner's advice.]

   c. Hobby; she did not follow the financial planner's advice to improve profit. [This answer is correct. When Mary ignored the advice she was given by the financial planner to improve profit, she demonstrated that she shows her dog with no motive of profit.]

   d. Hobby; showing dogs is always considered a hobby. [This answer is incorrect. While dog showing is more susceptible to the hobby loss rules, there may be some instances when showing dogs is considered a for-profit venture.]

2. When claiming a hobby deduction, which of the following would be considered a category 1 expense? **(Page 3)**

   a. Real estate taxes. [This answer is correct. Real estate taxes are a category 1 expense because they are otherwise deductible without regard to the profit motive.]

   b. Advertising expense. [This answer is incorrect. Advertising expense is an example of a category 2 expense because it would be deductible if the activity was engaged in for profit.]

   c. Insurance expense. [This answer is incorrect. Insurance expense is a category 2 expense. Category 2 expenses include normal trade or business expenses.]

   d. Depreciation expense. [This answer is incorrect. This is an example of a category 3 expense. While depreciation is considered a normal business expense, it results in a basis adjustment.]

Use the following information for questions 3 and 4.

John incurred the following income and expenses related to his hobby activity:

Advertising expense	$ 800	Income	$ 2,100
Insurance expense	$ 1,200		
Depreciation expense	$ 350		
Total expenses	$ 2,350		

3. Assuming John's AGI, before the hobby activity, is $75,000 for 2009, what is John's net miscellaneous itemized deduction? **(Page 3)**

   a. $558. [This answer is correct. John's expenses are only deductible to the extent of his hobby income, after applying the 2% of AGI limitation his net miscellaneous itemized deduction is $558. 2,100 − (2% × (75,000 + 2,100) = $558.]

   b. $1,542. [This answer is incorrect. This amount represents the 2% of AGI limitation. 2% × (75,000 + 2,100) = $1,542]

   c. $2,100. [This answer is incorrect. John's net miscellaneous itemized deduction is not equal to the amount of income provided by the hobby activity.]

   d. $2,350. [This answer is incorrect. John cannot deduct the full amount of expenses incurred. The amount of hobby income must be taken into account as well as the 2% of AGI limitation.]

4. Assuming John's AGI, before the hobby activity, is $140,000 for 2009, and he has $2,600 of other miscellaneous itemized deductions subject to the 2% of AGI floor, John's increase in taxable income due to the hobby loss is: **(Page 3)**

   a. $0. [This answer is incorrect. Since these expenses are subject to the 2% of AGI limitation, John will have net taxable income from his hobby.]

   b. $42. [This answer is correct. John's increase in taxable income due to the hobby loss is $42 (the increased AGI limitation of 2% × $2,100) since he was already able to use a portion of his miscellaneous itemized deductions.]

   c. $1,542. [This answer is incorrect. This amount represents the 2% of AGI limitation, which does not equal the increase in taxable income from the hobby loss.]

   d. $3,158. [This answer is incorrect. This amount represents the net miscellaneous itemized deductions allowed.]

5. Jason begins a new activity in 2007 in which he incurred a loss. He also incurred a loss in 2010. His activity is profitable in 2008, 2009, 2011, and 2012. Assuming the five-year test applies to the activity, the safe harbor rule applies only to: **(Page 3)**

   a. 2008. [This answer is incorrect. While the safe harbor period begins with 2008, the safe harbor rule does not apply to 2008.]

   b. 2011. [This answer is incorrect. This is the third profitable year in the safe harbor period beginning in 2008; however, it is not the only year in which the safe harbor rules are applied.]

   c. 2011 and 2012. [This answer is correct. 2011 was the third profitable year after the start of the five year period in which 2012 is also included. This goes along with the rules described in the IRS regulations.]

   d. 2008, 2009, and 2011. [This answer is incorrect. These years represent the first three years in which the activity was profitable; however, 2008 and 2009 are not covered under the safe harbor rules discussed in the IRS regulations.]

6. What form must a taxpayer file to delay the determination as to whether the safe harbor profit presumption rules apply until the close of the fourth tax year after the tax year in which the taxpayer first engages in the activity? **(Page 3)**

   a. Form 2106. [This answer is incorrect. Form 2106 is used for employees to claim the home office deduction.]

   b. Form 5213. [This answer is correct. To make a valid election, the taxpayer must file Form 5213. The election automatically extends the statute of limitations for all years in the postponement period until two years after the due date of the return for the last tax year in the five-year presumption period.]

   c. Form 8829. [This answer is incorrect. Sole proprietors compute their home office deduction on Form 8829.]

   d. Form 8903. [This answer is incorrect. Form 8903 is completed for the Domestic Producer Activities Deduction.]

7. Greg owns a working interest in several producing oil wells. Greg's adjusted taxable income for 2009 is $42,000. What is Greg's percentage depletion limit? **(Page 6)**

   a. $6,300. [This answer is incorrect. This answer incorrectly calculates the percentage depletion limit as adjusted taxable income multiplied by the 15% percentage depletion rate. 42,000 × 15% = $6,300.]

   b. $14,700. [This answer is incorrect. This amount represents Greg's adjusted taxable income minus Greg's percentage depletion limit.]

   c. $27,300. [This answer is correct. A taxpayer's total percentage depletion deduction for the year from all oil and gas properties cannot exceed 65% of taxable income, hence $42,000 × 65% = $27,300, the percentage depletion limit.]

   d. $42,000. [This answer is incorrect. Greg is not allowed to deduct the full amount of his taxable income; percentage depletion is limited to a certain percentage of taxable income.]

8. Allyson recently signed a lease agreement authorizing a gas well drilling company to drill a well on her 100 acres in rural America. The lease indicates she will be paid one-sixth of all gas produced by the well. The lease also states Allyson will not be responsible for any costs or charges for bringing the gas to the surface. Which of the following terms best describes the type of interest Allyson has in the gas well? **(Page 6)**

   a. Working interest. [This answer is incorrect. The scenario indicates that Allyson will not be responsible for the costs of bringing the gas to the surface, therefore Allyson does not have a working interest in the gas well.]

   b. Royalty interest. [This answer is correct. A royalty interest owner receives a portion of the minerals produced by the well owner.]

Deductions for a Home Office

To deduct home office expenses, a taxpayer must use the space *exclusively* and *regularly*:

1. as a principal place of business,
2. as a place to meet or deal with clients and customers in the normal course of business, or
3. "in connection with" the business if the space is a separate structure from the residence (e.g., a barn or detached garage).

Home office deductions are available to both self-employed taxpayers and employees. However, if the taxpayer is an employee, the business use of the home must be for the convenience of the employer, and the space must be used exclusively and regularly for job-related activities. As a practical matter, it is difficult for employees to pass these tests. If the employee also has an office furnished by the employer, it is unlikely that working at home is for the employer's convenience. However, a home office is for the convenience of the employer when the employer does not provide office space to the employee. In addition, taxpayers cannot avoid these rules by renting the home office to their employer.

Regular and Exclusive Use

As previously stated, to qualify for a home office deduction, a taxpayer must use the space both exclusively and regularly for the business purpose. Failing to meet either of these conditions results in the disallowance of a home office deduction.

Regular Use. Regular use means the taxpayer must use the portion of the home in the business activity on a continuing basis. Although the portion of the home is used exclusively (see following discussion) for the business purpose, it will not qualify for the home office deduction if use is only occasional. Thus, a dentist who used his home office to treat emergency patients failed to meet the regular use requirement because the use was only occasional and not to meet with patients in the normal course of his business.

Exclusive Use. Exclusive use means the taxpayer must use a specific portion of the home only for business purposes; there is no other use of the space. Two exceptions to the exclusive use rule are (1) storage of inventory or product samples if the home is the sole fixed location of the trade or business, and (2) certain daycare facilities. Space used for these purposes can also be used for personal purposes.

The exclusive use test can be very restrictive. In *Cook*, an attorney was denied deductibility for a portion of his residence used as a home office because he failed to meet the exclusive use test. While the residence was in fact the principal place of business for the law practice, the portions used for business were also personally used by the attorney and his family after business hours and presumably on weekends and holidays. Thus, the space used for the law practice failed the exclusive use test and the entire home office deduction was denied. In *Salih*, a doctor was denied a home office deduction for failure to provide evidence that an office containing a television and a VCR had no personal use. In *Anderson*, a bed and breakfast proprietor was denied deduction for the portion of his home used 75% for business and 25% for personal purposes.

A home office does not need to be a separate room or permanently partitioned portion of a room. Any "separately identifiable" area can serve as an office. Thus, a corner of a room with a desk and file cabinet could qualify as a home office.

Multiple Businesses. A taxpayer can operate two or more businesses using a single home office and still meet the regular and exclusive use requirements. However, each business must separately meet the requirements to sustain the deduction. Using a home office for employment-related duties could taint the deduction for a self-employment (e.g., a sideline) business. If at least one of the activities fails the Section 280A requirements, no home office deduction is allowed for any activity.

Example 1C-1 Regular and exclusive use—employee with a sideline business.

Joe is a CPA on the staff of a local accounting firm. Joe occasionally brings work home for his own convenience during busy season and uses a room over the garage as an office. He also prepares tax returns on the

side and reports the income on a Schedule C as a sole proprietor. Joe meets the Section 280A(c) requirements of regular use of the office space for his sole proprietorship. However, since the office was not used exclusively for the sole proprietorship and the work performed there as an employee was for Joe's convenience and not for the convenience of the employer, no home office deduction is allowed.

Principal Place of Business

In the landmark *Soliman* case, the Supreme Court identified two factors for determining whether a home office qualifies as the taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location and (2) the time spent at each place.

The "relative importance" test is analyzed first and, if no definitive answer is reached, the "time" test is considered. In analyzing the relative importance of the activities performed at each location, the point where clients are met or goods and services are delivered must be given great weight. Whether the functions performed at home are essential to the business, while relevant, is not controlling, and the availability of alternate office space is irrelevant.

However, in *Popov*, the 9th Circuit Court of Appeals overturned a Tax Court decision regarding a musician's business use of the home. The *delivery of services analysis*, which is part of the *relative importance* test, was not an appropriate framework for determining whether a home office deduction was appropriate for the musician who practiced at home for four to five hours a day. The appeals court decision stated, "It is possible, of course, to wrench musical performance into a 'delivery of services' framework, but we see little value in such a wooden and unblinking application of the tax laws." Therefore, the court moved to the *time spent at each place* test. Since the musician spent substantially more time practicing at home than performing away from home, the home office deduction was allowed.

In Rev. Rul. 94-24, the IRS provided several examples illustrating how these tests will be applied. In addition, the IRS reiterated the Court's finding in *Soliman* that, in some cases, application of the relative importance and the time tests may result in a determination that a taxpayer has no principal place of business for home office deduction purposes.

Administrative and Management Activities. A home office deduction is allowed if (1) the office is used exclusively and regularly by the taxpayer to conduct administrative or management activities of the taxpayer's business, and (2) there is no other fixed location of the business where the taxpayer conducts substantial administrative or management activities of the business. This definition expands the *Soliman* decision, allowing many more taxpayers to meet the definition of principal place of business.

Example 1C-2 Taxpayer's principal place of business.

Taylor is a self-employed contractor who builds single family homes. She maintains an office at home where she spends a significant amount of time working on building plans, ordering materials, calling subcontractors, doing payroll, keeping books, paying bills, and conducting other administrative and managerial duties. The room is used for no other purpose. She can claim a deduction for having a home office because she uses the space exclusively and regularly to conduct administrative or management activities of her trade or business, and no significant administrative or management activities are conducted elsewhere.

The taxpayer can have another office away from the residence and still claim the home office deduction if the criteria are met. The correct test to apply is where the administrative or management work is actually done—not where it could be done. Therefore, although there is another office away from home that can be used for administrative and managerial work, the taxpayer can still claim the home office deduction if he or she chooses to do the work at home.

Example 1C-3 Principal place of business when the taxpayer has an office outside the home.

Assume the same facts as in Example 1C-2, except that Taylor also has an office in a high-rise building where she meets with clients, works on building plans, orders materials, meets subcontractors, and performs other tasks directly related to the business of building houses. She continues to work at home doing payroll, keeping books, paying bills, and conducting other administrative and managerial duties.

Taylor can claim a home office deduction because she uses the home office exclusively and regularly to conduct administrative or management activities, and there is no other fixed location where she conducts substantial administrative or management activities.

Computing the Home Office Deduction

The home office deduction rules cover different kinds of direct and indirect expenses, including utilities, insurance, property taxes, and depreciation. Direct expenses (e.g., repairs made to the specific room used for business) are deducted in full (subject to the income limitation discussed later). The computation of the home office deduction for indirect expenses (i.e., expenses that benefit the entire home) is based on the allocation of the home office usage versus total usage. Determining the portion of a dwelling used for business can be done using any reasonable method under the circumstances, including allocations based on either square footage or number of rooms used for business to total rooms in the house. However, at least one court held that square footage was the more appropriate measure where the rooms in the home were not of approximately equal size. Total area is not defined, but in *Moretti* the court allowed the taxpayer to consider only living space in determining total square footage; thus, the garage was excluded, which increased the taxpayer's business-use percentage.

Special Rules for In-home Daycare Facilities. For daycare facilities, usage also considers the amount of time used. Rev. Rul. 92-3 provides a formula for allocating expenses for a daycare facility. The computation allocates expenses based on square footage and number of hours of business usage. In determining the square footage of the home used for business, the ruling allows a room that is available during the day and regularly used for daycare (e.g., a bathroom) to be treated as used during every hour of the business day for daycare (even if it is not in use during every hour of the business day for business). To qualify for these special rules for the home office deduction, the daycare facility must be licensed or approved under the taxpayer's respective state laws (or exempt from these requirements).

Example 1C-4 Home office deduction based on ratio of time used—daycare facilities.

Nancee Kamp operates a licensed daycare facility in her home. The daycare operates from 8 a.m. to 3 p.m., five days a week, and uses 50% of the house's square footage. Nancee spends an additional hour each day preparing for and cleaning up after the children and preparing meals for when they are present during the day. Her home office percentage for deductions is computed as follows:

$$\frac{\text{8 (daily hours of daycare)}}{\text{24 (total hours in day)}} \times \frac{\text{5 (number of days daycare is operated)}}{\text{7 (total number of days in week)}} = \frac{5}{21}$$

$$\frac{\text{Business portion of home}}{\text{Total area of home}} = \frac{1}{2}$$

Home office percentage = $^5/_{21} \times {}^1/_2 = 11.9\%$

Nancee is entitled to deduct 11.9% of household expenses as home office expenses subject to the income limitation discussed later. Part I of Form 8829 (Expenses for Business Use of Your Home) is used to determine the business-use portion of the home and has three lines devoted to homes used for daycare.

Income Limitation. The deduction for business use of the home (other than from otherwise deductible expenses, such as mortgage interest and real estate taxes) is limited to net income from the business. The deductions cannot create or increase a loss from the business.

To determine the limitation, business use of home deductions are claimed in the following order:

1. Business percentage of the expenses allowable as deductions in any case (e.g., qualified mortgage interest and real estate taxes). These expenses are fully deductible even if they exceed the net income from the business.

2. Other expenses for the business use of the home (e.g., repairs and maintenance, utilities, and insurance).

3. Depreciation of the home office space.

Example 1C-5 Home office deduction limited to net income.

Jane Smith operates a sales business from her home, which qualifies as her principal place of business and as a home office. Her office takes up 20% of her home, based on square footage. Jane has the following income and expenses attributable to her sales business for the year:

Gross profit (after cost of goods sold)		$ 7,200
Business expenses:		
Supplies	(640)	
Labor	(1,740)	(2,380)
Net income before home office expense		4,820
Home office expenses:		
Qualified mortgage interest	12,500	
Property taxes	2,500	
Total interest and taxes	15,000	
Business percentage	× 20%	
Business interest and taxes		$ (3,000)
Net income before other office expenses		1,820
Other office expenses:		
Insurance	1,200	
Repairs and maintenance	800	
Utilities	1,500	
Miscellaneous expense	1,500	
Total other office expenses	5,000	
Business percentage	× 20%	
Business other office expenses		$ (1,000)
Net income before depreciation		820
Depreciation expense	1,270	
Net income limitation		(820)
Net income		$ -0-

Because of the net income limitation, $450 ($1,270 − $820) of depreciation is disallowed. This amount can be carried forward to the next year.

Sole proprietors compute their home office deduction on Form 8829 (Expenses for Business Use of Your Home). Form 8829 requires disclosure of the method used for calculating the taxpayer's business-use percentage and limits business expenses to the net income from the activity. It also requires disclosure of the business basis of the home subject to depreciation. The allowable expense attributable to the business use of the home is carried to Schedule C.

Form 8829 is used only for sole proprietors. Employees must claim the home office deduction on Form 2106 (Employee Business Expenses). The expense flows to Schedule A, subject to the 2% of AGI limitation. Qualified residential interest and taxes are fully deductible on Schedule A without limitation (i.e., not reported as miscellaneous itemized deductions), but they reduce the business income available for offset by other home office deductions. Farmers report the expense on Schedule F. Partners report the expense on Schedule E. Form 8829 can be used as a worksheet to compute the home office deduction.

Example 1C-6 Using gain from the sale of business equipment to increase home office deductions.

Assume the same facts as stated in Example 1C-5 except Jane has decided to sell her company truck exclusively used in her business. The truck had an adjusted basis of $15,500 and Jane was able to sell the truck for $17,000 resulting in a gain of $1,500. This increases the income of the business activity, thus increasing the limitation on depreciation and avoiding any carryover with the net result offsetting $450 of the gain. Form 4797 would be completed as required, then the gain would be added to the amount of Schedule C line 29 tentative profit (loss), reported on line 8 of Form 8829.

Depreciating a Home Office. When a portion of a residence is converted to business use, its basis for depreciation is the lesser of:

1. the adjusted basis, including improvements, of the portion of the home allocated to the office space on the date of conversion; or

2. the fair market value (FMV) of the portion of the home allocated to the office space at the time of conversion.

Property converted from residential to business use must be depreciated using the method and recovery period in effect in the year of conversion. The method that applied when the property was originally acquired is irrelevant. Thus, a part of a residence converted to business use in 2009 is depreciated over 39 years under MACRS.

Example 1C-7 Computing depreciation when a portion of a residence is converted to a home office.

Buddy Love is an architect doing business as a sole proprietor. He has owned a home since 1990 and until recently rented office space for his business in a downtown building. In July 2009, Buddy converted his garage into office space and moved his business to his home office.

To compute depreciation for the home office, Buddy's basis will be the lower of (1) the cost or other basis of the home allocated to the garage (net of land) plus the improvements made to convert the garage to an office, or (2) the FMV of the converted office space at the time of conversion. In addition, Buddy must use a 39-year recovery period, beginning July 2009, since the home office is considered nonresidential real property.

An income-producing activity does not always qualify as a business. For example, use of an office to keep records regarding an investment activity does not qualify as business use. In such cases, no home office deduction is allowed.

SELF-STUDY QUIZ

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

9. In which of the following scenarios would the taxpayer be eligible to deduct home office expenses?

    a. Ellen, a lawyer for a major firm, occasionally meets with clients at her home office.

    b. Larry, a tax accountant, prepares tax returns at his dining room table before family dinner.

    c. June, a sole proprietor, only performs her business at her home office, which she locks after her office hours.

    d. Felix, an employee, has an office at his law firm but prefers to do business from his home.

10. Henry is a sole proprietor who performs his business at home in his office. He works in his office five days a week. On the weekends his daughter uses his office to do homework. Based on the information given, which of the following conditions prohibit Henry from a home office deduction?

    a. Regular use.

    b. Exclusive use.

    c. Principal place of business.

    d. Multiple businesses.

11. What case allowed a home office deduction to a musician based on the time spent at each place test?

    a. *Popov.*

    b. *Salih.*

    c. *Anderson.*

    d. *Cook.*

12. All of the following information is necessary to compute a taxpayer's home office deduction when operating a daycare facility ***except***:

    a. Total area of home.

    b. Number of hours of business.

    c. Number of days daycare is operated.

    d. How many children attend the daycare.

13. Matt operates a licensed daycare facility at his home. The daycare is open Monday thru Saturday from 9 a.m. to 4 p.m. He uses 50% of his house's square footage for the daycare. What will Matt's home office percentage be?

    a. 10.4%.

    b. 12.5%.

    c. 14.3%.

    d. 50%.

14. Employee home office expenses are stated on which of the following?

    a. Schedule A.

    b. Schedule C.

    c. Schedule F.

    d. Schedule E.

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.)**

9. In which of the following scenarios would the taxpayer be eligible to deduct home office expenses? **(Page 16)**

   a. Ellen, a lawyer for a major firm, occasionally meets with clients at her home office. [This answer is incorrect. Because Ellen meets occasionally with clients at her home office, she fails the regular use requirement and would not qualify for the home office deduction.]

   b. Larry, a tax accountant, prepares tax returns at his dining room table before family dinner. [This answer is incorrect. Larry would not qualify for the home office deduction because the dining room is used for personal purposes as well. Larry fails the exclusive use requirement.]

   c. June, a sole proprietor, only performs her business at her home office, which she locks after her office hours. [This answer is correct. June would qualify for the home office deduction because it is her principal place of business which is used regularly and exclusively for her business.]

   d. Felix, an employee, has an office at his law firm but prefers to do business from his home. [This answer is incorrect. Because Felix has an office furnished by his employer, it is unlikely that working at home is for the convenience of the employer. Felix would not qualify for the home office deduction.]

10. Henry is a sole proprietor who performs his business at home in his office. He works in his office five days a week. On the weekends his daughter uses his office to do homework. Based on the information given, which of the following conditions prohibit Henry from a home office deduction? **(Page 16)**

    a. Regular use. [This answer is incorrect. Based on the information given, it is clear that Henry regularly uses his home office to perform business.]

    b. Exclusive use. [This answer is correct. Because Henry allows his daughter to use his office on the weekend, his home office does not qualify for the home office deduction. There must be no other use of the space to qualify for the deduction.]

    c. Principal place of business. [This answer is incorrect. Henry performs his business at home, making it the principal place of business.]

    d. Multiple businesses. [This answer is incorrect. Henry only performs one business at home; therefore, this would not be the reason he is denied the home deduction.]

11. What case allowed a home office deduction to a musician based on the time spent at each place test? **(Page 16)**

    a. *Popov.* [This answer is correct. In the Popov case, the 9th Circuit Court of Appeals overturned a Tax Court decision regarding a musician's business use of the home. Since the musician spent substantially more time practicing at home than performing away from home, the home office deduction was allowed.]

    b. *Salih.* [This answer is incorrect. In the Salih case, a doctor was denied a home office deduction for failure to provide evidence that an office containing a television and a VCR had no personal use.]

    c. *Anderson.* [This answer is incorrect. In the Anderson case, a bed and breakfast proprietor was denied deduction for the portion of his home used 75% for business and 25% for personal purposes.]

    d. *Cook.* [This answer is incorrect. In the Cook case, an attorney was denied deductibility for a portion of his residence used as a home office because he failed to meet the exclusive use test.]

12. All of the following information is necessary to compute a taxpayer's home office deduction when operating a daycare facility **except**: **(Page 16)**

    a. Total area of home. [This answer is incorrect. Knowing the total area of the home is information that is necessary to compute the appropriate allocation of expenses. The percentage of business usage is calculated based on the square footage used for business divided by the total square footage of the home.]

    b. Number of hours of business. [This answer is incorrect. The number of hours of business usage is required information in determining the home office deduction for daycare facilities. The special rules for in-home daycare facilities do not require exclusive use, but allocates the expenses based on the amount of time used.]

    c. Number of days daycare is operated. [This answer is incorrect. The number of days the daycare is operated is used in determining the home office deduction for daycare facilities per the formula provided by an IRS revenue ruling.]

    d. How many children attend the daycare. [This answer is correct. Knowing how many children attend the daycare is not necessary in determining the home office deduction. The guidance in an IRS revenue ruling provides a formula for allocating expenses based on square footage and number of hours of business usage.]

13. Matt operates a licensed daycare facility at his home. The daycare is open Monday thru Saturday from 9 a.m. to 4 p.m. He uses 50% of the home's square footage for the daycare. Calculate Matt's home office percentage for deductions. **(Page 16)**

    a. 10.4%. [This answer is incorrect. This amount represents the home office percentage as if the daycare was only open five days. [(7/24 × 5/7) × ½] = 10.4%]

    b. 12.5%. [This answer is correct. This amount correctly allocates the number of hours and days open to the percentage of square footage used. [(7/24 × 6/7) × ½] = 12.5%]

    c. 14.3%. [This answer is incorrect. This amount incorrectly calculates the home office percentage based on an eight-hour work day. [(8/24 × 6/7) × ½] = 14.3%]

    d. 50%. [This answer is incorrect. The percentage of square footage used (50%) must be multiplied by the percentage of time in use to determine the allocation percentage.]

14. Employee home office expenses are claimed on which of the following? **(Page 16)**

    a. Schedule A. [This answer is correct. Employees must claim the home office deduction on Form 2106. The expense flows to Schedule A, subject to the 2% of AGI limitation.]

    b. Schedule C. [This answer is incorrect. The allowable expense attributable to the business use of the home is carried to Schedule C for sole-proprietors, but not for employees.]

    c. Schedule F. [This answer is incorrect. Farmers report home office expenses on Schedule F.]

    d. Schedule E. [This answer is incorrect. Partners report home office expenses on Schedule E.]

Business Investigation and Start-up Costs

Individuals starting a new business or acquiring the assets of an existing business often incur expenses, which can be considerable, in the investigation and acquisition phase before actual business operations begin. Absent any special provision in the Code, such expenses would be capital in nature since they would not be incurred in carrying on a trade or business. Therefore, Congress introduced IRC Sec. 195 so taxpayers could deduct business start-up costs that would be deductible under IRC Sec. 162 if they were incurred in a trade or business.

Distinguishing Deductible and Amortizable Costs (Section 195) from Capitalized Costs [Section 263(a)]

Start-up costs are expenses that would be deductible if incurred by an active trade or business, but do not include interest, taxes, or research and experimental expenditures (whose treatment is governed by other statutory provisions). They generally are segregated into two broad categories—investigatory expenses and preopening costs. Investigatory expenses are those incurred before reaching a decision to acquire or create a business. They include, but are not limited to, expenses for the analysis or survey of potential markets, products, the labor supply, and transportation facilities. If incurred in the acquisition of an existing business, such expenses are subject to the Section 195 allowance only if the taxpayer has an equity interest in, and actively participates in, the management of the business. Preopening costs are incurred after a taxpayer decides to establish or acquire a business, but before the day the business actually begins. Such costs include, but are not limited to, advertising; salaries and wages paid to employees being trained and their instructors; travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; and salaries or fees paid or incurred for executives, consultants, and for similar professional services. Costs associated with for-profit activities (which may later become an active trade or business) are deductible under Section 212 and should not be capitalized as Section 195 start-up expenses.

The issue of which amounts qualify as Section 195 expenses was impacted by the Section 263(a) regulations because they changed the rules regarding which amounts qualify as Section 162-type expenses. Amounts that must be capitalized under the Section 263(a) regulations do not qualify as Section 195 expenses. Instead, these capitalized amounts may (or may not) be amortized or depreciated under other tax rules. In general, the Section 263(a) regulations require:

1. Capitalization under Reg. 1.263(a)-4 for amounts paid to:

    a. Acquire certain intangible assets, including but not limited to an ownership interest in another entity such as a corporation or partnership.

    b. Create an intangible, limited to those assets described in the regulations (i.e., if the asset is not described in the regulations, it does not have to be capitalized).

    c. Create or enhance a separate and distinct intangible asset, defined as a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal, or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged separate and apart from a trade or business.

    d. Create or enhance future benefits to be identified in yet-to-be published IRS guidance.

    e. Facilitate the acquisition or creation of intangible assets previously described.

2. Capitalization under Reg. 1.263(a)-5 for amounts paid to facilitate the acquisition of assets constituting a trade or business; the acquisition of an ownership interest in a business when the taxpayer and the target entity are considered related parties after the transaction; the acquisition of an ownership interest in the taxpayer; certain business entity restructuring, reorganization, capitalization and recapitalization transactions; the formation or organization of a disregarded entity; the acquisition of capital, including stock issuances or borrowing transactions; or the writing of an option.

Amounts capitalized under these provisions are generally added to the tax basis of the intangible asset being acquired or created. Capitalized amounts for acquired Section 197 intangibles are amortized over 15 years.

Generally capitalized amounts for created intangibles should be amortized under the 15-year rule (25-year rule in the case of certain amounts paid for real estate) of Reg. 1.167(a)-3. These regulations apply to intangible assets created (and amounts paid or incurred) on or after December 31, 2003.

Example 1D-1 Identifying methods of treating preopening expenditures.

FastCo incurred preopening expenditures to recruit and train employees in connection with opening a new retail store that was separate and apart from its existing manufacturing operation. These expenditures and any preopening expenditures to advertise the new retail business are Section 195 expenses. Such expenditures are Section 162-type expenditures that are not required to be capitalized under the Section 263(a) regulations. These expenditures are eligible for Section 195 treatment.

Also, FastCo incurred the following preopening expenditures that *are* capitalized under the Section 263(a) regulations:

1. Amounts paid to acquire a lease agreement for the new retail store and the transaction costs to acquire or create the lease (e.g., attorneys fees to negotiate an agreement). These capitalized amounts are amortized over the life of the lease.

2. Prepaid expense items covering the next 16 months, such as prepayments for liability and casualty insurance coverage for the retail store and any prepaid rent for the retail location are deducted in the periods to which they relate.

3. For liability protection reasons, FastCo established a new single-member LLC (SMLLC) for the retail operation. The amounts paid to facilitate the formation or organization of the SMLLC are capitalized under the Section 263(a) regulations. Apparently, there is no provision that allows amortization for these amounts.

The Section 263(a) regulations include several exceptions to avoid capitalization under the regulations. (Start-up costs that are not required to be capitalized under the Section 263(a) regulations are capitalized under IRC Sec. 195.) The most important exceptions are:

1. The $5,000 *de minimis* rule for created contract right intangibles.

2. The 12-month rule for created intangibles with short lives.

3. For transaction costs in general: the exceptions for employee compensation, overhead, and *de minimis* costs of $5,000 or less.

4. For transaction costs specifically to facilitate the creation of financial interest intangibles and contract right intangibles: the exception for the cost of activities performed before the applicable bright-line date.

5. For costs to facilitate the formation or organization of a disregarded entity [e.g., an SMLLC or Qualified Subchapter S Subsidiary (QSUB)]: the exceptions for employee compensation, overhead, and *de minimis* costs of $5,000 or less.

Steps for Classifying Preopening Expenditure. The following procedural steps should be used to classify preopening costs incurred in connection with business expansions and acquisitions:

1. Not considering the Section 263(a) regulations, would the expenditure be currently deductible under IRC Sec. 162 if it was incurred by an existing business? If yes, go to Step 2. If no, capitalization is required under some other rule (e.g., the Section 248 rule for costs to organize a corporation).

2. Must the expenditure generally be capitalized under the Section 263(a) regulations? If yes, go to Step 3. If no, proceed directly to Step 5.

3. Does an exception in the Section 263(a) regulations negate the capitalization requirement? If yes, proceed directly to Step 5. If no, go to Step 4.

4. The expenditure must be capitalized under the Section 263(a) regulations. Determine if there is a tax rule that permits amortization or depreciation.

5. The expenditure is not required to be capitalized under the Section 263(a) regulations. Either deduct the amount currently under IRC Sec. 162 or, if a separate entity or dissimilar line of business is involved, capitalize the amount and treat as Section 195 expenses.

Business Expansion Costs. Taxpayers can currently deduct start-up expenditures to expand an existing business that are ordinary and necessary business expenses (Section 162-type expenses). For example, in TAM 9645002, Section 162 deductions were allowed for a retailer's business expansion costs to establish additional stores as part of a long-term expansion program. Expansion costs are currently deductible Section 162 expenses even when the same-line-of-business expansion is accomplished through an acquisition (e.g., when a chain of retail stores expands by acquiring the assets of another retail chain). In such case, the costs of employee hiring, relocation, and training and travel costs for visiting employees of the acquiring taxpayer are Section 162-type expenses that are currently deductible when paid or incurred.

Section 162 current deductions are not allowed when the expansion is accomplished by setting up a separate taxable entity, such as a corporate subsidiary or when a separate taxable entity is used to implement a same-line-of-business expansion. For example, the stock of the target business could be purchased by an acquiring holding company, or the target's assets could be purchased by a newly formed subsidiary owned by the acquiring taxpayer. In such cases, Section 195 treatment applies to expansion costs that would otherwise be currently deductible under IRC Sec. 162.

Same-line-of-business expansion/acquisition costs and dissimilar-line-of-business acquisition costs that must be capitalized under the Section 263(a) regulations do not qualify as currently deductible Section 162 expenses, nor do they qualify as Section 195 expenses. Instead, amounts required to be capitalized under the Section 263(a) regulations may (or may not) be eligible for amortization or depreciation under other tax rules. Some amounts may qualify for the exceptions in the Section 263(a) regulations that avoid capitalization (e.g., the $5,000 *de minimis* rule previously mentioned).

Making the Election to Deduct Start-up Costs

Start-up expenses must generally be capitalized and cannot be deducted. However, taxpayers can deduct (in the tax year an active trade or business begins) the lesser of: (1) the start-up expenditures for the active trade or business; or (2) $5,000, reduced (but not below zero) by the amount by which such expenditures exceed $50,000. Any remaining start-up expenditures are deductible ratably over 180 months beginning with the month in which the active trade or business begins. Similar rules apply to organizational costs for corporations and partnerships.

Alternately, the entity may choose to forgo the deemed election by clearly electing to capitalize (and not deduct) its start-up expenditures on a timely filed federal income tax return (including extensions) for the tax year in which the active trade or business begins. The election either to deduct or capitalize start-up expenditures is irrevocable and applies to all start-up expenditures of the business.

Example 1D-2 Claiming the deduction for Start-up Costs.

Jerry incurs $52,000 of start-up costs on October 27, 2009 for his car wash that began business in November 2009. Jerry's 2009 deduction is $3,544 [$5,000 − $2,000 (start-up costs over $50,000) + $544 ($49,000 ÷ 180 × 2 months)]. The remaining $48,456 is deductible ratably over the next 178 months at $272.22 per month.

Variation: Assume the same facts, except that Jerry incurs $90,000 of start-up costs. His 2009 deduction is $1,000 ($90,000 ÷ 180 × 2 months); i.e., he deducts the entire $90,000 ratably ($500 per month) over 180 months beginning in November 2009.

Treatment of Costs after Disposition or Abandonment of Business

The start-up expenditure must be for a business actually entered into. If a business is completely disposed of before the end of the amortization period, the unamortized start-up expenditures may be deducted as an ordinary loss

under IRC Sec. 165 and should be claimed as a miscellaneous itemized deduction (subject to the 2% limitation) on Schedule A of Form 1040.

The treatment of start-up expenditures when the taxpayer never enters into a business is not as clearly defined. Individuals may not deduct losses under IRC Sec. 165 unless they are related to business or profit-making activities or are the result of a casualty or theft. Rev. Rul. 57-418 holds that losses incurred in the search for a business or investment are deductible only when the activities are more than investigatory, the taxpayer actually entered a transaction for profit, but the project is later abandoned. In Rev. Rul. 77-254, the IRS took this analysis one step further to provide that a taxpayer will be considered to have entered a transaction for profit if, based on all the facts and circumstances, he has gone beyond a general investigatory search for a new business or investment to focus on the acquisition of a *specific* business or investment. The ruling also held that expenses related to the decision of whether to enter a trade or business (and which trade or business to enter) are personal and not deductible.

How to Dispose of a Sole Proprietorship

When a sole proprietor sells or otherwise discontinues his business, numerous tax issues must be addressed. The disposition is often reported in various places on the return for such year, and recapture provisions can lead to additional income.

Gain or Loss upon Disposition

When a sole proprietor sells the entire business, it is not treated as a single asset but, instead, as a sale of each individual asset comprising the business. Gain or loss is reported for each business asset and is determined based on the difference between the allocable sales price and adjusted tax basis. SE income does not include gains or losses (whether capital, Section 1231, or ordinary) from sales of business property other than inventory or stock in trade.

The character of the gain or loss for each business asset depends on the nature of the asset. Thus, the sale may be reported in different places in the taxpayer's return. For example, gain or loss from the sale of real or depreciable property used in the business is generally reported on Form 4797. Here, gains subject to depreciation recapture are reported in Part III while other gains and losses are reported in Parts I and II. Gains and losses from the disposal of capital assets are reported on Schedule D. Any gain attributable to self-created goodwill is normally reported as a capital gain and is long-term or short-term depending on how long the business was held. Acquired goodwill that is treated as a Section 197 intangible asset is a Section 1231 asset when disposed. The sale of any inventory or stock in trade is reported on Schedule C and is included in the taxpayer's self-employment (SE) tax computation.

Example 1E-1 Reporting the sale of a sole proprietorship.

Since 1994, Ann has owned a retail shop that she operates as a sole proprietorship. Ann decides to retire, so she sells the retail store on June 7, 2009, receiving $175,000 in cash. The following schedule shows how the sales proceeds were allocated, Ann's adjusted basis in each, and where the components of the sale are reported on Ann's 2009 return. (She held all of the assets sold for more than one year.) Ann also reports the income and deductions from the store's operations through June 7 on Schedule C.

Description of Asset	Allocated Sales Price	Adjusted Basis	Gain or (Loss)	Where Reported on Form 1040
Inventory	$ 50,000	$ 55,000	$ (5,000)	Schedule C
Furniture and Fixtures	15,000	12,000	3,000	Form 4797, Part III
Building	60,000	30,000	30,000	Form 4797, Part III
Land	30,000	18,000	12,000	Form 4797, Part I
Goodwill (not Section 197 asset)	20,000	—	20,000	Schedule D, Part II
Totals	$ 175,000	$ 115,000	$ 60,000	

Covenants Not to Compete

It is not unusual for a taxpayer who sells a business to enter into a covenant not to compete as part of the sales transaction. Income from a covenant not to compete is generally ordinary income not subject to SE tax unless the seller continues to provide consulting services to the buyer. If not subject to SE tax, this income should be reported on the "Other income" line on page 1 of Form 1040. Otherwise, it is reported on Schedule C.

Recapture Income

When business property is disposed of or otherwise ceases to be used in a trade or business, several recapture provisions can apply that may alter the character or amount of income recognized. The sale of depreciable property at a gain can result in ordinary income recapture, depending on the type of property.

If a Section 179 deduction was previously claimed on Section 1245 property and such property is sold, the Section 179 deduction amount is treated as depreciation for purposes of computing Section 1245 recapture. If the property is not sold but ceases to be used in a trade or business, a portion of the Section 179 deduction originally claimed is recaptured as ordinary income.

Automobiles and other listed property are subject to recapture provisions (for Section 179 expense as well as bonus depreciation) under IRC Sec. 280F when business use of these assets originally exceeded 50% but later falls to 50% or less. This is likely to occur when a sole proprietor uses an automobile in his business but converts it to personal use when the business is sold or discontinued.

Short Tax Year Depreciation

In the year a sole proprietorship is sold or otherwise disposed of, the business will have a short tax year unless the disposition occurs on the last day of the tax year. Special rules apply for calculating depreciation in a short tax year, including a short tax year in which the property is disposed of. Generally, depreciation on property that was placed in service in a full tax year but disposed of in a short tax year is computed using the midpoint of the short year.

SELF-STUDY QUIZ

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

15. Which of the following is a preopening cost?

    a. Experimental expenditures to create a new product line.

    b. Survey of potential markets when deciding whether to start a new business.

    c. Analysis of potential products to produce or market.

    d. Legal fees paid to assist in acquiring the franchise.

16. Which of the following would **not** qualify as a Section 162 expense?

    a. Expenditures to expand an existing business.

    b. Same-line-of-business expansion through an acquisition.

    c. Expansion accomplished by setting up a separate taxable entity.

    d. Costs of employee hiring related to same-line-of-business expansion.

17. Mark incurs start-up expenses of $54,000 on June 27, 2009 for his flower shop that began business in July 2009. What is Mark's 2009 deduction? (Round to the nearest dollar.)

    a. $1,000.

    b. $1,800.

    c. $2,767.

18. Allison, a sole proprietor, sold her business on September 23, 2009. The following is a description of assets, sales price, adjusted basis, and gain or loss.

Description of Asset	Allocated Sales Price	Adjusted Basis	Gain or (Loss)
Inventory	25,000	20,000	(5,000)
Furniture	35,000	30,000	5,000
Land	15,000	5,000	10,000
Goodwill (not Section 179 asset)	10,000	—	10,000

    Where would Allison report the gain of furniture?

    a. Schedule C.

    b. Form 4797, Part III.

    c. Form 4797, Part I.

    d. Schedule D, Part II.

19. Ramsden, a sole proprietorship has been looking for a buyer for the business for several years. Although the owner, Mr. Rams, had tried to avoid purchasing another vehicle for the business, an unforeseen accident caused the purchase of a delivery vehicle. The vehicle was placed in service during the last fiscal year. During the current fiscal year, Mr. Rams has found a buyer for his business. Mr. Rams expects the purchase to close during the current fiscal year and he expects to file a tax return for a short tax year. Which of the following accurately describes how the recently purchased delivery truck will be depreciated? (**Note:** Assume no accelerated depreciation method applies to the asset.)

    a. Depreciation will be computed for a full tax year.

    b. Depreciation will be not be computed for the year of disposition.

    c. Depreciation will be computed using the mid-year convention.

    d. Depreciation will be computed using the midpoint of the short tax year.

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.)**

15. Which of the following is a preopening cost? **(Page 25)**

    a. Experimental expenditures to create a new product line. [This answer is incorrect. Experimental expenditures are governed by other statutory provisions and are not considered a preopening cost.]

    b. Survey of potential markets when deciding whether to start a new business. [This answer is incorrect. Surveying potential markets and the labor supply are examples of investigatory expenses which are incurred before reaching a decision to acquire or create a new business.]

    c. Analysis of potential products to produce or market. [This answer is incorrect. Analyzing products and transportation facilities available are examples of investigatory expenses. Investigatory expenses are those incurred before reaching a decision to acquire or create a new business.]

    d. Legal fees paid to assist in acquiring the franchise. [This answer is correct. Preopening costs are incurred after a taxpayer decides to establish or acquire a business but before the day the business actually begins. Such costs include; travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; and salaries or fees paid or incurred for executives, consultants, and for similar professional services.]

16. Which of the following would **not** qualify as a Section 162 expense? **(Page 25)**

    a. Expenditures to expand an existing business. [This answer is incorrect. Taxpayers can currently deduct start-up expenditures to expand an existing business that are ordinary and necessary business expenses as Section 162-type expenses.]

    b. Same-line-of-business expansion through an acquisition. [This answer is incorrect. Expansion costs are currently deductible Section 162 expenses even when the same-line-of-business expansion is accomplished through an acquisition.]

    c. Expansion accomplished by setting up a separate taxable entity. [This answer is correct. Section 162 current deductions are not allowed when the expansion is accomplished by setting up a separate taxable entity. When a separate entity or a dissimilar line of business is involved, the amounts are capitalized and treated as Section 195 expenses.]

    d. Costs of employee hiring related to same-line-of-business expansion. [This answer is incorrect. The costs of employee hiring, relocation, and training and travel costs for visiting employees of the acquiring taxpayer are Section 162-type expenses that are currently deductible when paid or incurred.]

17. Mark incurs start-up expenses of $54,000 on June 27, 2009 for his flower shop that began business in July 2009. What is Mark's 2009 deduction? (Round to the nearest dollar.) **(Page 25)**

    a. $1,000. [This answer is incorrect. This amount represents $5,000, reduced by the amount by which the start-up expenditures exceed $50,000. The remainder of the start-up expenses are deductible over a certain number of months.]

    b. $1,800. [This answer is incorrect. This amount does not take into account the amount over $50,000 reduced from $5,000. [(54,000/180) $\times$ 6]= $1,800.]

    c. $2,767. [This answer is correct. To determine the deduction for start-up costs, first subtract the amount over the $50,000 threshold from $5,000. The remainder of the start-up costs are deductible ratably over a 180-month period. [(5,000 $-$ 4,000) + ((53,000/180) $\times$ 6)]=$2,767.]

18. Allison, a sole proprietor, sold her business on September 23, 2009. The following is a description of assets, sales price, adjusted basis, and gain or loss.

Description of Asset	Allocated Sales Price	Adjusted Basis	Gain or (Loss)
Inventory	25,000	20,000	(5,000)
Furniture	35,000	30,000	5,000
Land	15,000	5,000	10,000
Goodwill (not Section 179 asset)	10,000	—	10,000

Where would Allison report the gain on furniture? **(Page 28)**

a. Schedule C. [This answer is incorrect. The sale of inventory or stock in trade is reported on Schedule C.]

b. Form 4797, Part III. [This answer is correct. Gains subject to depreciation recapture are reported in Part III of Form 4797.]

c. Form 4797, Part I. [This answer is incorrect. Gains not subject to depreciation recapture, such as land, are recorded on Form 4797, Part I.]

d. Schedule D, Part II. [This answer is incorrect. Gains and losses from the disposal of capital assets are reported on Schedule D.]

19. Ramsden, a sole proprietorship has been looking for a buyer for the business for several years. Although the owner, Mr. Rams, had tried to avoid purchasing another vehicle for the business, an unforeseen accident caused the purchase of a delivery vehicle. The vehicle was placed in service during the last fiscal year. During the current fiscal year, Mr. Rams has found a buyer for his business. Mr. Rams expects the purchase to close during the current fiscal year and he expects to file a tax return for a short tax year. Which of the following accurately describes how the recently purchased delivery truck will be depreciated? (**Note:** Assume no accelerated depreciation method applies to the asset.) **(Page 28)**

a. Depreciation will be computed for a full tax year. [This answer is incorrect. Computing depreciation on a business asset for a full tax year is part of the process of calculating depreciation for a short tax year. The full year depreciation amount must then be multiplied by the partial year percentage.]

b. Depreciation will be not be computed for the year of disposition. [This answer is incorrect. Some amount of depreciation is computed for the year of disposition as long as the van was in service a portion of the year.]

c. Depreciation will be computed using the half-year convention. [This answer is incorrect. In this scenario, no accelerated depreciation method applies. However, the half-year convention can be applied in a short-year.]

d. Depreciation will be computed using the midpoint of the short tax year. [This answer is correct. Depreciation on property that was placed in service in a full tax year but was disposed of in a short tax year is computed using the midpoint of the short year per an IRS revenue procedure.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TDBTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Having no other information, which of the following activities would be more susceptible to the hobby loss rules?

   a. Selling cars.

   b. Racing horses.

   c. Owning a retail pet store.

   d. Being a full-time farmer.

2. Albert a race car driver has just been told his racing is considered a hobby. He has been looking over his expenses trying to determine what category under the ordering system they should be placed. What category would his utilities expense of $600 be considered?

   a. Category 1.

   b. Category 2.

   c. Category 2 and 3.

   d. Category 3.

Use the following information for questions 3 and 4

Priscilla incurred the following income and expenses related to her hobby activity:

Advertising expense	$850	Income	$1,500
Insurance expense	$900		
Total expenses	$1,750		

Her AGI before her hobby activity was $60,000 for 2008. She also had other miscellaneous itemized deductions of $1,300.

3. What is Priscilla's net miscellaneous itemized deduction?

   a. $1,230.

   b. $1,500.

   c. $1,570.

   d. $1,750.

4. Priscilla's increase in taxable income due to the hobby loss is:

   a. $0.

   b. $30.

   c. $1,230.

   d. $1,500.

5. Anthony began a new activity in 2005 in which he incurred a loss. He also incurred a loss in 2007 and 2008. His activity is profitable in 2006, 2009, and 2010. Assuming the five-year test applies to the activity, the safe harbor period begins with what year?

   a. 2005.

   b. 2006.

   c. 2009.

   d. 2010.

6. Which of the following represents an intangible drilling cost (IDC)?

   a. Fuel.

   b. Pumps.

   c. Drilling rigs.

   d. Storage facilities.

7. Gina owns a working interest in several producing oil wells. Gina's adjusted taxable income for 2009 is $35,000; she also has add back percentage depletion tentatively allowed of $2,200. What is Gina's percentage depletion limit?

   a. $5,250.

   b. $5,580.

   c. $22,750.

   d. $24,180.

8. Which of the following is **not** a test that must be met for an employee to deduct home office expenses?

   a. The business use of the home must be for the convenience of the employee.

   b. The taxpayer must use the space as a principal place of business *exclusively* and *regularly*.

   c. The business use of the home must be for the convenience of the employer.

   d. If the space is a separate structure from the residence, the taxpayer must use the space *exclusively* and *regularl*y "in connection with" the business.

9. In which of the following scenarios would the taxpayer be eligible to deduct home office expenses?

   a. Anna, a self-employed lawyer, has a home office. She either meets clients at her home or at the office she rents inside a bank.

   b. Hugh, a doctor, occasionally meets emergency patients on the weekend at his home office.

   c. Moe, a self-employed CPA, prepares all his clients tax returns at his home office. He allows only clients in his office.

   d. Penny runs two businesses out of her home office. On the weekends the office is turned into a playroom for her children.

10. When determining whether a home office qualifies as the taxpayer's principal place of business which two tests are analyzed?

    a. Relative importance and time.

    b. Regular and exclusive use.

    c. Relative importance and regular use.

    d. Exclusive use and time.

11. Which of the following is an example of a direct expense when computing the home office deduction?

    a. Utilities expense.

    b. Insurance expense.

    c. Property taxes.

    d. Replacing drywall in home office.

12. Jerry operates a licensed daycare facility at his home. The daycare is open Monday thru Friday from 7a.m. to 4 p.m. He uses 75% of his house's square footage for the daycare. What will Jerry's home office percentage be?

    a. 20.1%.

    b. 26.8%.

    c. 37.5%.

    d. 75%.

13. Business use of home deductions are claimed in the following order:

    a. Business percentage of the expenses allowable as deductions in any case, depreciation of the home office space, and other expenses for the business use of the home.

    b. Business percentage of the expenses allowable as deductions in any case, other expenses for the business use of the home, and depreciation of the home office space.

    c. Depreciation of the home office space, other expenses for the business use of the home, and business percentage of the expenses allowable as deductions in any case.

    d. Other expenses for the business use of the home, depreciation of the home office space, and business percentage of the expenses allowable as deductions in any case.

14. Caleb has the following expenses related to opening his business:

    State taxes.....$3,200
    Interest expense.....$750
    Advertising.....$1,000
    Wages paid to employees being trained.....$800

    Which expenses are **not** deductible as start-up costs?

    a. Advertising.

    b. State taxes and interest expense.

    c. Interest expense and advertising.

    d. Wages paid to employees being trained.

15. Which of the following should be capitalized under Reg. 1.263(a)-5?

    a. Amounts paid to create an intangible asset.

    b. Amounts paid in the acquisition of certain intangible assets.

    c. Amounts paid to enhance a separate and distinct intangible asset.

    d. Amounts paid to facilitate the acquisition of assets that constitute a business.

16. Brent incurs start-up expenses of $70,000 on September 25, 2009, for his tire shop that began business in October 2009. What is Brent's 2009 deduction? (Round to the nearest dollar.)

    a. $333.

    b. $1,167.

    c. $5,000.

    d. $6,000.

17. Neals Villman sells his entire sole proprietorship. In accordance with the tax rules, the sales price was allocated to each asset based on sales price and adjusted tax basis. One of the assets sold was inventory, which was sold at a gain. How is the gain on the sale of inventory recorded for tax purposes?

    a. As a capital gain.

    b. As a Section 1231 gain.

    c. As self employment income.

    d. As an ordinary gain.

18. Ashley, a sole proprietor, sold her business on November 16, 2008. The following is a description of assets, sales price, adjusted basis, and gain or loss.

Description of Asset	Allocated Sales Price	Adjusted Basis	Gain or (Loss)
Inventory	30,000	15,000	15,000
Furniture	15,000	12,000	3,000
Building	75,000	50,000	25,000
Land	20,000	30,000	(10,000)
Goodwill (not Section 197 asset)	10,000	—	10,000

What amount will be reported on Form 4797, Part III?

a. $3,000.

b. $15,000.

c. $18,000.

d. $28,000.

Lesson 2: Farm Income and Expenses (Schedule F)

INTRODUCTION

An individual taxpayer is considered a farmer if he cultivates, operates, or manages a farm for gain or profit, either as an owner or a tenant. Farmers generally report income and expenses on Schedule F (Profit or Loss From Farming). Many farms are operated by part-time farmers, often at a loss that may offset income from other sources. However, such losses may be limited under the hobby loss rules or the passive activity loss rules.

Although dealers in personal property are generally prohibited from using the installment method for reporting sales, farmers disposing of any property used or produced in the trade or business of farming can use the installment method. Farmers can use the installment method for such sales for both regular tax and AMT purposes.

The following income is *not* reported on Schedule F:

1. Rent based on farm production or crop shares when the recipient does not materially participate [under the self-employment (SE) tax rules]. Such income is reported on Form 4835 (Farm Rental Income and Expenses), which feeds into Schedule E.

2. Rent from land that is based on a flat charge (reported on Schedule E).

3. Sales, exchanges, or involuntary conversions of farm property.

4. Sales of livestock held for draft, breeding, sporting, or dairy purposes [reported on Form 4797 (Sales of Business Property)].

5. Casualties or theft of farm property (including livestock held for draft, breeding, sport, or dairy purposes) reported on Form 4684 (Casualties and Theft), which feeds into Form 4797 (when used) or directly to Form 1040 (on the Form 4797 line).

Qualifying farmers, defined as those receiving at least two-thirds of their gross receipts from farming, can avoid quarterly estimated tax payments. Instead, they may make one estimated payment by January 15 following their year-end or file their return and pay all tax by March 1 following their year-end.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:
- Determine the tax treatment of cooperative patronage distributions and CCC loans.
- Describe the rules for prepaid farming expenses, the deferral of certain farming income and depreciation methods for farm property.
- Define uniform capitalization rules and commodity hedging transactions.
- Define crop-share rental reporting.

How to Report Cooperative Patronage Distributions

Patronage Dividends

Cooperative (co-op) patronage dividends are distributions of profits to patrons made by a cooperative. They are generally reported as income on lines 5a and 5b of Schedule F (Profit or Loss From Farming). The patronage dividend is similar to a rebate on purchases. Patrons receive notice of their allocation of patronage dividends, which generally include a cash distribution at least equal to 20% of the total dividends. Patronage dividends in excess of cash distributed are allocated to the farmer's equity account on the co-op's books, and are generally paid to the patron many years later. A qualified written notice of allocation, as defined in IRC Sec. 1388(c), is a certificate treated as the equivalent of cash both for deduction by the co-op and taxation to the patron.

A patronage dividend allocable to the purchase of nondeductible personal, living, or family items is not taxable. (See Example 2A-1.) Additionally, a patronage dividend is not taxable if it is related to the purchase of a capital asset

or depreciable property used in the taxpayer's trade or business. Instead, it reduces the asset's basis as of the first day of the tax year. If the dividends exceed the asset's unrecovered basis, the excess is reported as income on Schedule F. A patronage dividend related to normal farming activities (i.e., the sale of farm commodities or the purchase of farm supplies, feed, and crop inputs) is current taxable income reported on Schedule F.

A nonqualified written notice of allocation is a certificate giving written notice of an allocation that does not meet all the requirements of a qualified written notice. The receipt of an allocation designated on a nonqualified written notice is not taxable; the taxable event occurs when the taxpayer receives money or property in redemption of the certificate.

Example 2A-1 Taxable patronage dividends.

Roger is a self-employed farmer who purchases supplies from the Farmers Co-op. During the year, he received $250 cash from the co-op that represented 20% of his patronage dividend of $1,250. (He received a qualified written notice of allocation.) Roger's records indicate he conducted $30,000 of business with the co-op. This included $27,000 of farm-related purchases and sales and $3,000 (or 10%) of personal expenses.

The full patronage dividend of $1,250 must be reported as gross income on Schedule F, line 5a, even though only 20% was distributed in cash. However, 10% of Roger's patronage dividend allocation represents a rebate on personal purchases and is subtracted to arrive at a net taxable amount on line 5b of $1,125.

Losses on Co-op Equity

Cooperatives occasionally have suffered financial problems, failed, or been subject to takeover transactions or mergers. A financially distressed cooperative may permanently reduce the member's equity account, issuing a notification to the member indicating that his equity account has been adjusted downward or eliminated. This write-off is deductible on Part II of Schedule F in the year the write-down occurs. Since the co-op equity has been previously recognized as income, any reduction to equity is always deductible on Schedule F. Self-employment income is also reduced for that year even though the taxpayer may no longer be actively engaged in farming.

Per-unit Retains

A per-unit retain allocation is an amount paid to patrons for products marketed for them and is fixed in amount (computed without regard to the co-op's net earnings). These allocations are paid in cash, property, or qualified or nonqualified certificates. Per-unit retains generally are treated the same as patronage dividends. Qualified certificates are taxable when received, and nonqualified certificates are taxable when redeemed for cash or property.

Example 2A-2 Qualified per-unit retains.

Larry is a self-employed dairy farmer. He received a Form 1099-PATR showing he received qualified per-unit retain certificates of $2,250. He did not receive any of the per-unit retains in cash. He received no other patronage dividends. His Form 1099-PATR shows $2,250 in box 3 (per-unit retain allocations). The entire $2,250 is shown as income on Schedule F, lines 5a and 5b.

Example 2A-3 Nonqualified per-unit retains.

Dan is a self-employed sugar beet farmer. He received a certificate from his sugar beet cooperative indicating he had been allocated a total of $4,550 of nonqualified per-unit retains for the year. In addition, he received a cash payment of $3,500 (reported on Form 1099-PATR, box 5) for the redemption of prior-year nonqualified per-unit retain certificates.

The $4,550 of nonqualified per-unit retains are not taxable currently and are not reflected on Schedule F or Form 1099-PATR. However, the nonqualified per-unit retains redeemed for cash are taxable in the year the cash is received and should be reported on Schedule F. Thus, Dan reports $3,500 on Schedule F, lines 5a and 5b.

Domestic Production Activities Deduction

Cooperatives engaged in the manufacturing, production, growth, extraction, or marketing of agricultural or horticultural products can claim the domestic production activities deduction (DPAD) attributable to certain qualified production activities income (QPAI). A cooperative can choose to pass through all, some, or none of the DPAD. Any DPAD allocated by the cooperative to the patron is based upon the patron's share of patronage dividends or per-unit retains attributable to QPAI of the cooperative. A cooperative's patronage dividends, per-unit retain allocations, and nonpatronage distributions do not impact its QPAI. To claim the patron's allocable deduction shown in box 6 of Form 1099-PATR, this amount must have been identified by the cooperative in a written notice mailed to the patron during the payment period. The patron's allocable deduction is claimed by entering the amount from box 6 of Form 1099-PATR onto line 21 of Form 8903 (Domestic Production Activities Deduction).

Example 2A-4 Domestic production activities deduction for co-op patron.

Assume the same facts as in Example 2A-3. In addition, Larry's Form 1099-PATR shows that his share of the co-op's DPAD (reported in box 6) is $75, which agrees with the amount the co-op reported earlier to Larry in a letter. Larry includes the $75 on line 21 of Form 8903 to calculate his DPAD on his personal return Form 1040 for the year. There is no wage limitation for a DPAD allocated from a co-op.

The Tax Treatment of CCC Loans

Cash-method farmers generally report income from the sale of crops in the year they are sold. A farmer enrolled in U.S. Department of Agriculture (USDA) grain programs may have the option of pledging some or all of the production to secure a Commodity Credit Corporation (CCC) loan. Farmers who take out CCC loans may report the loan proceeds as income in the year received (income method) or treat the amount as a loan (loan method). A taxpayer who chooses to include CCC loans in income can automatically switch from the income method to the loan method. This change is made on a cut-off basis and a Section 481(a) adjustment is neither permitted nor required (i.e., there is no forward spread of the impact of the change). Under the income method, the amount of CCC loans reported as income becomes additional tax basis in the crop. Farmers using the loan method have no additional basis in the crop. Instead, they may recognize income when the loan is repaid.

A taxpayer who forfeits grain to the USDA/CCC instead of repaying a loan receives Form 1099-A (Acquisition or Abandonment of Secured Property) from the USDA. The amount of debt satisfied by forfeiting the grain (i.e., the fair market value of the property) is reported in box 4.

Example 2B-1 Forfeiture to satisfy CCC loan.

John is a cash-basis farmer and reports his CCC loans on the income method. In 2008, John took out a $10,000 CCC corn loan and reported this as income on his 2008 Schedule F. In 2009, due to the difference in market prices, it was advantageous for John to forfeit the corn (basis $10,000) to the CCC rather than to repay the loan and market the crop. John received a 2009 Form 1099-A with the amount of $10,000 in box 4. John's 2009 Schedule F reports the 1099-A amount of $10,000 (on line 7b) but includes zero in taxable income (line 7c). This is because John had reported the $10,000 loan proceeds as income in 2008 and had basis in the forfeited crop equal to the forgiven loan.

Variation: Assume the same facts, except John reports CCC loans on the loan method. John's Schedule F for 2009 then includes $10,000 in income (reported on both lines 7b and 7c). When the loan method is used, a cash-basis farmer recognizes income when the crop is forfeited in satisfaction of the CCC loan.

Market Gain

The repayment amount of a CCC loan is generally the lesser of its amount or the prevailing world market price of the pledged commodity at the repayment date. Therefore, if the price of the commodity has fallen at that date, the farmer realizes a *market gain* (i.e., the excess of the loan proceeds over the repayment). The market gain is reported on CCC Form 1099-G), regardless of whether the taxpayer repays the loan in cash or with CCC certificates. Market gain is either reported as income or as a basis adjustment to the commodity, depending on the farmer's method for recognizing income on CCC loans.

Farmers who report CCC loans on the loan method report market gains as taxable income (i.e., on lines 6a and 6b of Schedule F) in the year received. The market gain has no impact on the basis of the commodity. Farmers who have elected to report CCC loans on the income method do not recognize the market gain when the loan is repaid. The market gain is reported on line 6a of Schedule F, but not included as a taxable amount on line 6b. Instead, it reduces the farmer's basis in the commodity, and will be recognized when the commodity is sold.

Example 2B-2 Market gain on CCC loans.

Walter, a cash-method cotton farmer, uses the loan method for CCC loans. In 2008 he pledged 1,000 pounds of cotton ($0 basis) as collateral for a $500 CCC loan. In March of 2009, when the price of cotton was $.42 a pound, he repaid the loan for $420 and in December of 2009, sold the cotton for $600. Walter has realized $80 ($500 − $420) of market gain, which is reported as taxable income on lines 6a and 6b of his 2009 Schedule F. In addition, Walter reports a $600 gain on the sale of his cotton in 2009.

Variation: Same facts as above, except that Walter has elected to report CCC loans as income. Then, in 2008, he would have recognized $500 of income when the loan was made (as if the cotton were sold for $500). In 2009, when the loan was repaid, Walter takes a basis in the cotton of $420. The $80 market gain is reported on Schedule F, line 6a, but not as a taxable amount on line 6b. When the cotton is sold in 2009, Walter recognizes $180 ($600 − $420) of gain.

The Tax Treatment of Prepaid Farming Expenses

General Rule

Cash and accrual-method taxpayers generally must capitalize prepaid expenses (although cash method taxpayers can deduct certain prepaids that provide a benefit that does not extend more than 12 months). However, these rules do not apply to expenses specifically addressed elsewhere in the Code. Therefore, prepaid farm expenses continue to be governed by IRC Sec. 464, which provides that cash-basis farmers can deduct prepaid expenses (e.g., feed, seed, fertilizer, other similar expenses, and certain poultry expenses) to the extent the prepaid expenses are 50% or less than the deductible nonprepaid expenses for the taxable year. The excess over 50% may only be deducted as the purchased items are consumed. For the 50% test, ordinary and necessary operating expenses of the farm, interest and taxes, and depreciation on farm equipment are considered. Costs that must be inventoried or capitalized are not included in the test.

Rev. Rul. 79-229 provides additional criteria for deducting prepaid farm expenses. (While the ruling deals specifically with prepaid feed, the IRS applies these criteria to all types of prepaid farm expenses.) The three additional tests are:

1. The expenditure must be an actual purchase, rather than a mere deposit to buy in the future. A cash method farmer should obtain an invoice that clearly specifies a definite quantity, quality, and price for the items purchased. There should be no right to refund or repurchase noted on the invoice.

2. The expenditure must have a business reason other than tax avoidance. Examples of business reasons for early purchase include securing adequate quantities, obtaining discounts, and the expectation of rising costs.

3. The expenditure must not result in a material distortion of income. Generally, purchases for the upcoming crop year would not distort income. Similarly, purchases of items such as feed would not normally distort income if they are reasonably expected to be consumed within the next 12 months.

Poultry Rule. Poultry expenses are subject to a special rule. If the poultry expenses meet the 50% test, the excess cost of poultry (including egg-laying hens and baby chicks) purchased for use in a trade or business must be capitalized and deducted ratably over the lesser of 12 months or their useful life. The cost of poultry purchased for resale is deducted in the tax year in which the poultry is sold.

Exceptions to the 50% Rule

Two exceptions exist to the 50% rule if the taxpayer is a "farm-related taxpayer." A farm-related taxpayer is a person (or family member) whose principal residence is on a farm or whose principal occupation is farming. For such an individual, the 50% test is waived and prepaid expenses may be deducted in full if he or she:

1. has prepaid farm expenses that are more than 50% of other deductible expenses because of a change in business operations directly attributable to extraordinary circumstances, such as drought or changes resulting from government crop diversion programs; or

2. has aggregate prepaid farm expenses for the preceding three tax years that are less than 50% of the aggregate other deductible expenses for those three tax years.

Example 2C-1 Prepaid farm expenses deduction is not limited.

John's farm expenses, including depreciation, are $100,000. Actual use or consumption occurred on $75,000 of these expenses. The $25,000 of prepaid expenses are fully deductible since they are less than $37,500 (50% of the deductible expenses of $75,000).

Example 2C-2 Prepaid farm expenses deduction is limited.

During 2009, John bought fertilizer ($4,000), feed ($1,000), and seed ($500) for use on his farm in 2010. Thus, his total prepaid farm supplies for 2009 are $5,500. John's other deductible farm expenses (including depreciation) for 2009 totaled $10,000. None of the exceptions to the 50% rule apply to John in 2009. Therefore, his 2009 deduction for prepaid expenses cannot exceed $5,000 ($10,000 × 50%). The excess prepaid expenses of $500 ($5,500 − $5,000) are deductible in the tax year the supplies are consumed (i.e., 2010).

Deferring Certain Livestock and Crop Income

Crop Insurance Proceeds

Cash-basis farmers can elect to include crop insurance proceeds in income for the tax year following the year in which the destruction or damage of crops occurred and the proceeds were received. To make this election, a farmer must state that under normal practice, more than 50% of the income from the damaged crops would have been included in income in a year following the year in which destruction or damage occurred.

This tax deferral option also applies to drought assistance and other relief payments to farmers under USDA programs. Certain government disaster payments, such as for flood and other natural disasters, are also eligible for the crop insurance tax deferral treatment. A farmer who receives multiple crop insurance and government disaster payments attributable to a single farming business must elect to treat these receipts in a consistent manner for a particular tax year, either including all in current income or electing to defer all to the following year.

Example 2D-1 Deferring crop insurance and disaster payments to the subsequent tax year.

Larry, a cash-basis farmer, suffered drought damage in 2009 that qualified him for USDA disaster assistance payments of $8,400. Also in 2009, a portion of his soybean crop was damaged by hail, and he received $2,000 of private crop insurance payments. Larry elected to defer these disaster and crop insurance payments by including an election statement in his 2009 return stating that the damaged crops would have been marketed in later years under his normal crop sale practices.

On his 2010 return, Larry reports the $10,400 of deferred insurance and disaster payments on line 8d of his Schedule F.

The election to defer crop insurance and disaster income may also be made via an amended return. Accordingly, if a taxpayer reported such income in 2009 (the year of receipt), meets the criteria for deferral, and finds that a lower tax rate applies in 2010, the 2009 return can be amended to defer the insurance and disaster income to 2010.

Livestock Sold Because of Adverse Weather Conditions

A cash-basis farmer who is forced to sell more livestock than normal due to drought, floods or other weather-related conditions may elect to include income from the sale of the additional livestock in the tax year following the year of sale. The election is available only if the taxpayer establishes that the sale would not have occurred but for the drought, flood, or other weather-related conditions that resulted in the area being designated as eligible for federal assistance. The income that may be deferred is based on the excess of the number of livestock sold in the year over the number that would have been sold had the farmer followed usual business practices in the absence of weather-related conditions. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other federal departments or agencies.

Example 2D-2 Sale of excess cattle due to flood.

Elmer, a cash-basis farmer, sells approximately 200 head of cattle in a normal year. As a result of severe flooding, Elmer sells 250 head during the current year at $300 per head, realizing $75,000 of income from this sale. Later that summer, the area was declared a disaster area and ruled eligible for federal disaster assistance. Elmer may defer $15,000 ($300 $\times$ 50) of income until the following year, representing the portion of the $75,000 (250 head) that exceeds the normal quantity sold (200 head per year).

The sale of livestock held for draft, breeding, or dairy purposes due to drought, floods or other weather-related conditions in excess of the number of such livestock that normally would have been sold is treated as an involuntary conversion if the livestock are replaced within four years after the end of the first tax year in which any part of gain from the conversion is realized.

Because of prolonged droughts in parts of the United States, the IRS has announced it will provide additional time to replace qualifying livestock that was sold as a result of drought. IRS Notice 2006-82 explains how a taxpayer can determine whether additional time is available. To assist taxpayers in determining whether the replacement period has been extended, the IRS publishes each September a list of counties that experienced exceptional, extreme, or severe drought for the 12-month period ending on the immediately preceding August 31.

The Depreciation of Farm Property

Property used in a farming business must be depreciated using the 150% declining balance method. This requirement applies to all assets used in the business of farming, not only agricultural equipment items. Thus, all depreciable assets associated with a Schedule F enterprise (including cars, computers, office fixtures, etc.) are subject to the slower 150% DB method, rather than the 200% DB MACRS method.

The business of farming includes (1) raising and harvesting crops; (2) raising, shearing, feeding, caring for, training, and managing animals; (3) operating a nursery or sod farm; (4) raising or harvesting trees bearing fruit, nuts, or other crops; and (5) raising ornamental trees (an evergreen tree is not considered an ornamental tree if it is more than six years old when severed from its roots).

For farm property placed in service after 1988 and before 1999, the recovery period for regular tax purposes is the regular MACRS recovery period while the recovery period for AMT purposes is the longer alternative depreciation system (ADS) recovery period based on the class life. Thus, an AMT adjustment must be computed even though both regular tax and AMT depreciation are computed using 150% DB. Beginning with property placed in service in 1999, however, the AMT recovery period conforms to the MACRS recovery period. Thus, there is no AMT adjustment with respect to farm property placed in service beginning in 1999; however, an AMT adjustment must still be computed for property placed in service after 1988 and before 1999.

SELF-STUDY QUIZ

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

20. In 2009, Fred purchased $20,000 of farm supplies and $5,000 of personal items from the local farmers co-op. He received $150 from the co-op that represented 20% of his patronage dividend of $750 (He received a qualified written notice of allocation.). What amount should Fred report as net taxable income on line 5b of Schedule F?

    a. $150.

    b. $600.

    c. $750.

21. Bob received a qualified written notice of allocation in 2008. In 2009, he received a $200 patronage dividend from the co-op based on his 2008 purchases. What amount should Bob report as net taxable income on Schedule F, line 5b in 2009?

    a. $0.

    b. $200.

22. John is a self-employed corn farmer. In 2009, he received cash from the corn co-op that represented 20% of his patronage dividend of $2,000. (He received a qualified written notice of allocation in 2009.) John conducted $25,000 of business with the co-op; this amount included $20,000 of corn-related sales and $5,000 of personal expenses. What is the net taxable amount John would record on line 5b of Schedule F?

    a. $0.

    b. $400.

    c. $1,600.

    d. $2,000.

23. Which of the following per-unit retains is **not** reported as income on Schedule F?

    a. Qualified per-unit retains.

    b. Unredeemed nonqualified per-unit retains.

    c. Cash received from redemption of prior-year's nonqualified retain certificates.

    d. Property received from redemption of prior-year's nonqualified retain certificates.

24. Pete is a cash-basis soybean farmer. In 2008, Pete took out a $5,000 CCC loan and reported this as income. In 2009, the value of the soybeans, which were pledged on the loan, dropped to $4,000 and Pete forfeited the soybeans rather than repay the loan. What amount should Pete report on Schedule F in 2009?

    a. $0.

    b. $1,000 loss.

    c. $4,000 income.

    d. $5,000 income.

25. Prepaid expenses may be deducted by a cash-basis farmer if certain criteria are met. Which of the following is **not** a criteria?

    a. Prepaid expenses are 50% or less than the deductible nonprepaid expenses.

    b. The expenditure must be an actual purchase.

    c. The expenditure must not result in a material distortion of income.

    d. The prepaid item must be used up within 12 months.

26. Chuck paid $60,000 for farm expenses that were consumed during the year. Chuck also paid $40,000 in prepaid farm expenses. What amount may Chuck deduct for prepaid expenses assuming the 50% test is not waived?

    a. $0.

    b. $20,000.

    c. $30,000.

    d. $40,000.

27. Cash-basis farmers may defer the entire recognition of income resulting from the disaster for one year in all the following situations **except**:

    a. Crop insurance proceeds received due to hail damage.

    b. Income from the sale of livestock due to flooded pastures.

    c. USDA disaster assistance received due to drought damage to crops.

28. What method of depreciation is used for property used in a farming business?

    a. Straight-line.

    b. 150% declining balance.

    c. 200% declining balance.

    d. Sum-of-the-year digits.

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.)**

20. In 2009, Fred purchased $20,000 of farm supplies and $5,000 of personal items from the local farmers co-op. He received $150 from the co-op that represented 20% of his patronage dividend of $750. (He received a qualified written notice of allocation.) What amount should Fred report as net taxable income on line 5b of Schedule F? **(Page 41)**

    a. $150. [This answer is incorrect. The amount Fred received in cash is not the full amount. He is required to report the full amount under the Code. Further calculations are needed to arrive at taxable income.]

    b. $600. [This answer is correct. Fred must report the full patronage dividend of $750 less the rebate of 20% which represents a rebate of personal purchases.]

    c. $750. [This answer is incorrect. Fred must report the $750 patronage dividend on Schedule F, line 5a, but further calculations are needed to arrive at the amount of net taxable income he reports on line 5b.]

21. Bob received a qualified written notice of allocation in 2008. In 2009, he received a $200 patronage dividend from the co-op based on his 2008 purchases. What amount should Bob report as net taxable income on Schedule F, line 5b in 2009? **(Page 41)**

    a. $0. [This answer is correct. A qualified written notice of allocation is a certificate treated as the equivalent of cash both for deduction by the co-op and taxation to the patron. Therefore, Bob will recognize the income in 2008, the year he received the qualified notice.]

    b. $200. [This answer is incorrect. Bob would not report the dividend as income for 2009, because he received a qualified written notice of allocation in 2008 of $200.]

22. John is a self-employed corn farmer. In 2009, he received cash from the corn co-op that represented 20% of his patronage dividend of $2,000. (He received a qualified written notice of allocation in 2009.) John conducted $25,000 of business with the co-op; this amount included $20,000 of corn-related sales and $5,000 of personal expenses. What is the net taxable amount John would record on line 5b of Schedule F? **(Page 41)**

    a. $0. [This answer is incorrect. If the patronage dividend is related to normal farming activities, it is current taxable income and reported on Schedule F.]

    b. $400. [This answer is incorrect. This amount represents the cash distribution related to the patronage dividend. $2,000 × 20% = $400. The taxable amount is not limited to the cash distribution.]

    c. $1,600. [This answer is correct. John's personal expenses represent 20% of the business he conducted with the co-op. Therefore, 20% of John's patronage dividend allocation represents a rebate on personal purchases and is subtracted to arrive at the net taxable amount.]

    d. $2,000. [This answer is incorrect. Only a patronage dividend on deductible expenditures must be included in income.]

23. Which of the following per-unit retains is **not** reported as income on Schedule F? **(Page 41)**

    a. Qualified per-unit retains. [This answer is incorrect. Qualified certificates are taxable when the notice is received.]

    b. Unredeemed nonqualified per-unit retains. [This answer is correct. Nonqualified retain certificates are not taxable until redeemed for cash or property.]

    c. Cash received from redemption of prior-year's nonqualified retain certificates. [This answer is incorrect. Income is recognized when nonqualified retain certificates are redeemed.]

d. Property received from redemption of prior-year's nonqualified retain certificates. [This answer is incorrect. The redemption of nonqualified retain certificates produces taxable income whether the redemption is in cash or property.]

24. Pete is a cash-basis soybean farmer. In 2008, Pete took out a $5,000 CCC loan and reported this as income. In 2009, the value of the soybeans, which were pledged on the loan, dropped to $4,000 and Pete forfeited the soybeans rather than repay the loan. What amount should Pete report on Schedule F in 2009? **(Page 43)**

a. $0. [This answer is correct. Pete has a basis in the forfeited crop of $5,000 (The amount of the CCC loan reported as income.) and receives $5,000 loan forgiveness. As a result, Pete has no income in 2009.]

b. $1,000 loss. [This answer is incorrect. In this scenario, the amount reported on Schedule F is not the difference between the loan amount and the value of the crop in the subsequent year.]

c. $4,000 income. [This answer is incorrect. The current value of the soy bean crop is not the amount reported on Schedule F.]

d. $5,000 income. [This answer is incorrect. Since Pete reported the loan proceeds as income in 2008, he has a basis in the forfeited crop. However, if Pete used the loan method, his taxable income would have been $5,000 for 2009.]

25. Prepaid expenses may be deducted by a cash-basis farmer if certain criteria are met. Which of the following is **not** a criterion? **(Page 44)**

a. Prepaid expenses are 50% or less than the deductible non prepaid expenses. [This answer is incorrect. Prepaid farm expenses are only deductible to the extent they do not exceed 50% of deductible expenses for the taxable year that are not prepaid.]

b. The expenditure must be an actual purchase. [This answer is incorrect. For prepaid farm expenses to be deductible, the expense must be for an actual purchase and not just a deposit to buy.]

c. The expenditure must not result in a material distortion of income. [This answer is incorrect. Prepaid expenses are deductible unless the deduction distorts income for the year. Normally, expenses are only paid for items that will be used in the crop year.]

d. The prepaid item must be used up within 12 months. [This answer is correct. Generally prepaid expenses are deductible if the benefit does not extend more than 12 months. However, these rules do not apply to farm expenses which are governed by Code Section 464.]

26. Chuck paid $60,000 for farm expenses that were consumed during the year. Chuck also paid $40,000 in prepaid farm expenses. What amount may Chuck deduct for prepaid expenses assuming the 50% test is not waived? **(Page 44)**

a. $0. [This answer is incorrect. Prepaid farm expenses are deductible, but are limited by the 50% rule per the Internal Revenue Code.]

b. $20,000. [This answer is incorrect. The 50% limit applies, but the limit is not 50% of the prepaid amount.]

c. $30,000. [This answer is correct. Prepaid farm expenses are deductible, but are limited to 50% of deductible nonprepaid expenses for the taxable year per the Internal Revenue Code.]

d. $40,000. [This answer is incorrect. The deduction for prepaid expenses is limited because Chuck does not meet one of the two exceptions to the 50% rule.]

27. Cash-basis farmers may defer the entire recognition of income resulting from the disaster for one year in all the following situations **except**: **(Page 45)**

    a. Crop insurance proceeds received due to hail damage. [This answer is incorrect. Crop insurance proceeds can be deferred to the year following the year of destruction or damage under the Code if more than 50% of the income from the damaged crops would have been included in income in the following year.]

    b. Income from the sale of livestock due to flooded pastures. [This answer is correct. Farmers may elect to defer income for one year from livestock sold because of adverse weather conditions under the Code but only the portion due to adverse weather conditions.]

    c. USDA disaster assistance received due to drought damage to crops. [This answer is incorrect. Under the Code, USDA payments due to drought can be deferred for one year. A farmer who receives multiple crop insurance and government disaster payments attributable to a single farming business must elect to treat these receipts in a consistent manner for a particular tax year, either including all in current income or electing to defer all to the following year.]

28. What method of depreciation is used for property used in a farming business? **(Page 46)**

    a. Straight-line. [This answer is incorrect. Straight-line is a common depreciation method for financial accounting purposes, but cannot be used for farming purposes on Schedule F per the IRS.]

    b. 150% declining balance. [This answer is correct. The Internal Revenue Code states that the 150% declining balance method must be used when calculating depreciation on property used in a farming business.]

    c. 200% declining balance. [This answer is incorrect. Normally 200% declining balance depreciation is used for tax purposes; but for farming businesses, a different method is required by the Code.]

    d. Sum-of-the-year digits. [This answer is incorrect. Sum-of-the-year digits depreciation is not an acceptable method for tax purposes.]

The Uniform Capitalization Rules for Plants and Animals

General Rule

Uniform capitalization (UNICAP) rules require that direct costs and an allocable portion of indirect costs incurred in production activities be capitalized. However, many farming activities are exempt from the UNICAP rules. Specifically, for farming activities, the UNICAP rules only apply to the production, growing, or raising of property if it:

1. is produced by a farm entity required to use the accrual method of accounting (i.e., tax shelters, certain large farm corporations, and partnerships with a corporate partner); or

2. is a plant with a preproductive period of more than two years.

To assist taxpayers in determining which plants have a preproductive period in excess of two years, Notice 2000-45 contains a list of plants with a nationwide weighted average preproductive period in excess of two years. The list, which is not all-inclusive, will be updated periodically.

Absent an election out of UNICAP (see discussion following), direct and allocable indirect costs incurred to plant, cultivate, maintain, or develop plants with a preproductive period of more than two years must be capitalized. However, costs incurred to replant and maintain plants bearing an edible crop for human consumption may be expensed if the replanting was made necessary by freezing, drought, pests, or casualty. Replanting may occur on different property but must be undertaken by the same taxpayer.

Example 2F-1 Application of UNICAP to replanting after a freeze.

Carl has a large citrus grove operation. In May, 50% of his groves were permanently damaged by a freeze. Carl replanted the damaged trees, incurring considerable cost. Under IRC Sec. 263A(d)(2), he may currently deduct the replanting costs. However, any costs relating to the planting of a new grove (not related to the freeze) must be capitalized because the preproductive period of citrus trees is more than two years.

Election out of the UNICAP Rules

An individual farmer who grows plants with a preproductive period of more than two years may elect to not apply the UNICAP rules. This election does not apply to any costs involved in a citrus or almond grove that were incurred within the first four years that the trees were planted.

Two adverse consequences arise from electing out of the UNICAP rules:

1. Any plants otherwise subject to capitalization are treated as Section 1245 property upon disposition, requiring ordinary income recapture at the time of disposition to the extent that expenses would have been capitalized.

2. The alternative depreciation system (ADS) (straight-line method with longer term alternative lives) must be used to depreciate all property used predominantly in any farming business of the taxpayer or related person.

Example 2F-2 Election out of UNICAP rules.

Brian has previously grown only wheat and corn in his farming proprietorship and has not been subject to UNICAP because the preproductive period for these crops is less than two years. In 2009, Brian started an apple orchard and elected not to have the UNICAP rules apply. Brian makes the election by deducting preproduction costs on his 2009 Schedule F. He must use ADS for all property used primarily in his farming business (including assets involved solely in his grain farming operation) and placed in service when the election out of UNICAP is in effect.

Requirements for Substantiating Farm Vehicles

A taxpayer generally must be able to prove the following items to claim a deduction for vehicle expenses: (1) the amount of each separate expense, (2) the mileage for each business use of the vehicle, (3) the date of the expense

or use, and (4) the business reason for the expense or use. Typically, some type of account book, diary, log, or similar record supported by adequate documentary evidence (e.g., receipt) must be kept. Recordkeeping does not need to be done contemporaneously. However, records of business use made at or near the time of the expense and supported by sufficient documentary evidence are more credible than a statement prepared after the fact.

However, Temp. Reg. 1.274-6T(b) provides an exception to the recordkeeping requirement for vehicles used in the business of farming. If an owned or leased vehicle is used during most of a normal business day directly in the business of farming, instead of substantiating its use, the taxpayer may determine any deduction or credit for the vehicle as if the business use were 75% plus that percentage, if any, attributable to an amount included in an employee's gross income. If a taxpayer opts to satisfy the substantiation requirements of IRC Sec. 274(d) by using the 75% rule, he cannot use a different method in subsequent years. The converse is also true.

Example 2G-1 75% farm-use option for vehicle substantiation.

Dennis, a sole proprietor engaged in farming, owns a pickup and a car. Dennis keeps a mileage log for his car and averages 25% farm use. He claims deductions for the car on his tax return based on the 25% farm use. Dennis does not keep a mileage log for his pickup since he maintains that it is never used personally. Dennis has been claiming 100% business use for the pickup on his returns. Dennis is audited by the IRS on his 2009 tax return. The agent requests a log for the pickup and will not accept verbal documentation that the pickup use is all farm use. Dennis must provide a mileage log and cannot rely on the 75% safe harbor since he elected to use actual farm use for the pickup in the return subject to audit.

Commodity Hedging Transactions

Farmers sometimes enter into commodity hedging transactions to protect against unfavorable price fluctuations. These transactions can be in the form of commodity futures contracts, forward contracts, or options on futures contracts.

The character of gain or loss from these contracts was determined by the Supreme Court in the landmark case of *Corn Products Refining Co.* The Court held that corn futures purchased to protect a company from price increases that affected its manufacturing of syrups were *not* capital assets, and thus gains or losses from these holdings generated ordinary rather than capital gains or losses.

What Is a Hedging Transaction?

A hedging transaction is one entered into in the normal course of a taxpayer's business primarily to reduce the risk of:

1. price changes or currency fluctuations on ordinary property (i.e., property, the sale or exchange of which could not produce a capital gain or loss) that the taxpayer holds or will hold, or

2. interest rate or price changes or currency fluctuations on the taxpayer's ordinary obligations.

If not entered into to reduce risk, they are not considered hedging transactions. Instead, they are speculative transactions that give rise to capital gains or losses.

In agriculture, qualification of a futures contract, option agreement, or other contractual arrangement as a hedging transaction generally requires that three basic criteria are met:

1. the hedging contract is in commodities produced by the farmer and within the farmer's range of production;

2. the hedging contract protects the farmer from the risk of unfavorable price fluctuations (meaning that the contract secures a pricing opposite the farmer's physical position of commodities on hand or expected to be on hand or to be purchased, so as to constitute a price hedge); and

3. the farmer meets identification requirements in his or her records with respect to the hedging transaction, subject to specified time limits as discussed later in this lesson.

Example 2H-1 Common hedge transaction—grain farmer.

Terry is a corn and soybean producer who operates as a cash-method proprietor. In June, he notes that the price of corn is exceptionally high, but he anticipates that it will be lower at his October harvest. Under normal crop conditions, Terry produces about 60,000 bushels of corn. Accordingly, in June, Terry sells eight contracts of corn short (representing 40,000 bushels) locking in the current June sale price. When harvest occurs, if Terry's anticipation was correct, he will sell his crops from the field at a lower price. However, he will close his short sale in October by buying contracts of the lower priced corn, thus realizing a profit. Terry's profit on the corn short sale contracts will be ordinary (reported on line 10 of Schedule F), as it is a hedging transaction (for price protection) tied directly to his corn inventory.

Example 2H-2 Farm producer—speculative transaction.

Bart is a corn producer. At harvest in October, Bart must sell a substantial portion of his crop since he lacks sufficient storage space. However, he expects corn prices to rise, so Bart immediately acquires a long futures position in corn to replace the commodity he sold at harvest. Any gain or loss on this long position will be speculative and result in capital gain or loss treatment (reported on Schedule D) because it is not a transaction reducing risk.

Identifying Hedging Transactions

Taxpayers who enter into hedging transactions must identify them as such before the close of the day on which they are entered into. Acceptable identification methods include (1) placing hedging transactions in a separate account that has been identified as containing only hedges of a specified item or specified risk, or (2) making notations or other identifying marks within the books and records, such as designated marks on records of the transactions (i.e., trading tickets, purchase orders, or trade confirmations).

In addition to identifying hedging transactions, taxpayers must also identify the risk being hedged. This risk identification must be done within 35 days of entering into the hedging transaction. However, see Reg. 1.1221-2(g) for situations when the taxpayer's inadvertent error in properly identifying a hedge will be disregarded.

Reporting Crop-share Rental Arrangements

Farmers and other landowners often enter into crop-share arrangements for the rental of their land. The rent they receive in this kind of arrangement is based on a share of the crop or livestock produced on the land. The landowner is paid in kind with crops or livestock produced or with cash generated from their sale.

Regardless of whether the taxpayer uses a cash or accrual basis of accounting, amounts received in kind (including crops received under price-later and other deferred payment arrangements) are included in income when they are converted to cash or cash equivalent. If the landlord uses the crops as feed for his livestock, these crops are included in income at their FMV when they are fed to the livestock. In this case, the landowner would also receive a corresponding deduction in the same amount as feed expense.

When Are Crop-share Rents SE Income?

Crop share rents are self-employment (SE) income if they are derived under a rental arrangement between the landlord and the lessee that provides that the landlord will materially participate in the farming and the landlord does materially participate.

However, the 8th Circuit Court has ruled that rental income under a crop-share arrangement is SE income only if there is a connection between the rental income and the landlord's material participation (e.g., the payments vary based on the level of services provided). In the 8th Circuit's view, the mere existence of an agreement providing that the landlord will participate combined with material participation does not automatically subject the rents to SE tax. For example, rents under an agreement providing for participation that are comparable with market rates for use of the land could indicate that little, if any of the payments were connected to the landlord's participation. Then, the payments would not be SE income.

Reg. 1.1402(a)-4(b) provides guidance for determining whether the landlord materially participates. Factors to consider include making management decisions about (1) when and what to plant, (2) rotation of crops, and (3) the

kinds of machinery to be used. In addition, the IRS provides guidance in Pub. 225, "Farmer's Tax Guide," on what constitutes material participation. According to Chapter 12 of Pub. 225, a landlord materially participates if any of the following tests are met:

1. The landlord does any three of the following: (a) pays or stands good for at least half of the direct costs of producing the crop; (b) furnishes at least half the tools, equipment, and livestock used in producing the crop; (c) consults with the tenant; or (d) inspects the production activities periodically.
2. The landlord regularly and frequently makes management decisions that contribute substantially to the success of the enterprise.
3. The landlord works 100 hours or more over a period of five weeks or more in activities connected with the production of the crop.
4. The landowner's activities demonstrate that he is materially and significantly involved in the production of the farm products.

Reporting Crop-share Rents

Rental income that is subject to SE tax is reported on Schedule F (Profit or Loss from Farming), which flows to the Schedule SE. If the income is not subject to SE tax, it is reported on Form 4835 (Farm Rental Income and Expenses). Any net income/loss from crop-share rental is carried from Form 4835 to Schedule E. It generally is considered income/loss from rental real estate subject to the passive activity rules. However, if the property subject to the rental arrangement is essentially bare farmland where less than 30% of the unadjusted basis is depreciable, net income is recharacterized as portfolio. Losses that retain their passive status can qualify for the $25,000 rental real estate loss privilege per the instructions to Form 4835.

Example 2I-1 Crop-share rentals.

Tom owns 10,000 acres of farmland in Kansas. During 2009, he enters into an agreement with Gene whereby Tom leases Gene 2,000 acres to grow wheat in exchange for 20% of the wheat harvest for the year. Tom does not materially participate in the production or management of the crops.

Gene harvests 40,000 bushels of wheat during 2009 and delivers Tom his share in August. Tom stores his share of the grain at the elevator until September when it is sold for $3 per bushel. In this crop-share arrangement, Tom recognizes income from the crops received in kind when the crops are converted to cash. Thus, Tom recognizes $24,000 (20% $\times$ 40,000 bushels $\times$ $3) of income from crop-share rentals in 2009. (If Tom had stored the grain until 2010 before he sold it, he would have recognized the income in 2010.) Tom reports the $24,000 of income on Form 4835 because he does not materially participate (under the SE tax rule for farming) in the farming operation.

Rental income based on a flat fee (often referred to as cash rent) is reported directly on Schedule E if the landowner does not materially participate in the activity.

SELF-STUDY QUIZ

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

29. For farming activities subject to the UNICAP rules, which of the following costs must be capitalized?

    a. Direct costs and an allocated portion of indirect costs related to production activities.

    b. Replanting costs necessitated by a freeze to plants bearing edible crops for human consumption.

    c. All costs paid in cash.

30. Which of the following is **not** required information that is needed to deduct vehicle expenses when claiming actual use?

    a. Amount of each separate expense.

    b. Business use mileage.

    c. Date of the expense.

    d. Daily recording of costs.

31. Hedging transactions are entered into primarily to:

    a. Reduce risk.

    b. Earn a profit.

    c. Defer the recognition of income.

    d. Convert ordinary income into capital gains.

32. Crop share rentals based on a flat fee are reported on which of the following schedules when the landowner does not materially participate in the activity?

    a. Schedule A, Form 1040.

    b. Schedule C, Form 1040.

    c. Schedule E, Form 1040.

    d. Schedule F, Form 1040.

33. Neil and George enter into a crop-share arrangement. George owns the land and Neil agrees to raise the crop. George uses accrual basis accounting. Which of the following reflects how George should report the transaction on his income tax return when Neil delivers the crop in kind in 2009?

    a. George waits until 2010 to convert the crop to cash and reports the income in 2010.

    b. George uses $1,000 of the crop to feed his livestock and does not report the usage as a deduction for feed expense.

    c. George tells Neil when and what to plant and the kinds of machinery to use. George reports the net income from the sale of the crop in 2009 on IRS Schedule E, Form 1040.

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.)**

29. For farming activities subject to the UNICAP rules, which of the following costs must be capitalized? **(Page 52)**

    a. Direct costs and an allocated portion of indirect costs related to production activities. [This answer is correct. Uniform capitalization (UNICAP) rules require direct and allocable indirect costs incurred to plant, maintain, cultivate, or develop plants with a preproductive period of more than two years must be capitalized.]

    b. Replanting costs necessitated by a freeze to plants bearing edible crops for human consumption. [This answer is incorrect. Replanting costs may be expensed if the replanting was made necessary by freezing, drought, pests, or casualty per the UNICAP rules.]

    c. All costs paid in cash. [This answer is incorrect. Costs are expensed or capitalized based on the type of cost and not based on whether the cash or accrual method is used.]

30. Which of the following is **not** required information that is needed to deduct vehicle expenses when claiming actual use? **(Page 52)**

    a. Amount of each separate expense. [This answer is incorrect. To be deductible, expenses must be substantiated. Documentary evidence would include receipts, paid bills, or other corroborative evidence per an IRS temporary regulation.]

    b. Business use mileage. [This answer is incorrect. The percentage of total mileage that accounts for business use determines what percentage of the auto expenses that can be deducted as a business expense.]

    c. Date of the expense. [This answer is incorrect. Taxpayers must be able to prove the date the expense was incurred by maintaining an account book, diary, trip sheets, expense report, or other corroborative evidence.]

    d. Daily recording of costs. [This answer is correct. Taxpayers do not need to contemporaneously record vehicle expenses. However, records of business use made at or near the time of the expense and supported by sufficient documentary evidence are more credible than a statement prepared after the fact per an IRS temporary regulation.]

31. Hedging transactions are entered into primarily to: **(Page 53)**

    a. Reduce risk. [This answer is correct. Hedging transactions are entered into as protection against the risk of unfavorable price fluctuations. When identifying hedging transactions, taxpayers must identify the risk being hedged per the Internal Revenue Code.]

    b. Earn a profit. [This answer is incorrect. If not entered into to reduce risk, they are not considered hedging transactions. Instead, they are speculative transactions that give rise to capital gains or losses per the Internal Revenue Code.]

    c. Defer the recognition of income. [This answer is incorrect. Hedging transactions are not entered into to defer the recognition of income as defined in the Internal Revenue Code. However, taxpayers generally must follow the accounting and income recognition rules as prescribed in the Internal Revenue Code. These rules require that the gain or loss must reasonably match the timing of the gain or loss from the item being hedged.]

    d. Convert ordinary income into capital gains. [This answer is incorrect. Hedging transactions will not result in capital gains or losses. In the landmark case of *Corn Products Refining Co.,* the court held that gains or losses from these holdings generated ordinary rather than capital gains or losses.]

32. Crop share rentals based on a flat fee are reported on which of the following schedules when the landowner does not materially participate in the activity? **(Page 54)**

    a. Schedule A Form 1040. [This answer is incorrect. Itemized deductions, such as home mortgage interest and gifts to charity, are reported on Schedule A.]

    b. Schedule C Form 1040. [This answer is incorrect. Transactions related to self-employment income other than farming are reported on Schedule C.]

    c. Schedule E Form 1040. [This answer is correct. In the facts stated, the landowner does not materially participate in the farming activity, thus the farming activity is treated the same as any other rental activity and is reported on Schedule E.]

    d. Schedule F Form 1040. [This answer is incorrect. Although the rental income is related to farming activity, in this instance, the transaction is not reported on Schedule F because the landowner did not materially participate in the farming.]

33. Neil and George enter into a crop-share arrangement. George owns the land and Neil agrees to raise the crop. George uses accrual basis accounting. Which of the following reflects how George should report the transaction on his income tax return when Neil delivers the crop in kind in 2009? **(Page 54)**

    a. George waits until 2010 to convert the crop to cash and reports the income in 2010. [This answer is correct. Amounts received in kind are included in income when they are converted to cash. It does not matter if the taxpayer is cash or accrual basis of accounting per the IRS regulations.]

    b. George uses $1,000 of the crop to feed his livestock and does not report the usage as a deduction for feed expense. [This answer is incorrect. When George uses the crops to feed his livestock, the crops are included in income at their FMV. George would also deduct the same amount as feed expense.]

    c. George tells Neil when and what to plant and the kinds of machinery to use. George reports the net income from the sale of the crop in 2009 on IRS Schedule E, Form 1040. [This answer is incorrect. This scenario indicates that George is a material participant in the farming activity and should report and income from the transaction as self-employment income.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TDBTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

19. Which of the following sources of income would be reported on Schedule F?

    a. Rent from land that is based on a flat charge.

    b. Involuntary conversions of farm property.

    c. Sale of livestock for breeding.

    d. Sale of a corn crop.

20. Alex is a self-employed wheat farmer who purchases from the wheat co-op. During the year, he received $200 cash from the co-op that represented 20% of his patronage dividend. Alex conducted $20,000 of business with the co-op, including $17,500 of farm related purchases and $2,500 of personal expenses. What amount must be reported as gross income on line 5a of Schedule F?

    a. $200.

    b. $875.

    c. $1,000.

    d. $2,500.

21. In 2009, Harold received a cooperative patronage dividend of $300 cash from the co-op that represented 20% of his patronage dividend of $1,500. He had purchased $40,000 of supplies and $10,000 of personal items form the co-op in 2009. Harold received a qualified written notice of allocation. What amount must Harold include in net taxable income on line 5b of Schedule F?

    a. $300.

    b. $500.

    c. $1,200.

    d. $1,500.

22. Vern is a cash-basis wheat farmer. In 2008, he received an $8,000 CCC loan pledging wheat as collateral. Vern uses the loan method to account for the loan proceeds. In 2009, Vern forfeits the pledged wheat which was worth $6,000 at the time. For 2009, what amount of income should Vern report on Schedule F?

    a. $0.

    b. $2,000.

    c. $6,000.

    d. $8,000.

23. Prepaid farming expenses are deductible but are limited to 50% of nonprepaid expenses. The 50% test is waived in which of the following situations?

    a. The farmer has been farming for less than three years.

    b. The farmer is on an accrual basis.

    c. Prepaid expenses exceed 50% of nonprepaid expenses because of a drought.

    d. Prepaid expenses are for items which will be consumed in the next 12 months.

24. Farm property is depreciated using the declining balance method and what percentage?

    a. 100%.

    b. 125%.

    c. 150%.

    d. 200%.

25. In lieu of the recordkeeping requirement for vehicles used during most of a normal business day in farming, a taxpayer may deduct what amount?

    a. 75% of vehicle expenses.

    b. 75% of vehicle expenses plus the percentage included in an employee's gross income.

    c. 25% of vehicle expenses.

    d. An amount equal to the business use in the prior year.

26. UNICAP rules only apply to the production, growing, or raising of property if the property:

    a. Is produced on a farm required to use the accrual method or is a plant with a preproductive period of more than two years.

    b. Is produced on a farm required to use the cash method or is a plant with a preproductive period of more than two years.

    c. Is produced on a farm required to use the accrual method or is a plant with a preproductive period of less than two years.

    d. Is produced on a farm required to use the cash method or is a plant with a preproductive period of less than two years.

27. When a farmer enters into a commodity hedging transaction, any gain that results is treated as:

    a. Capital gain.

    b. Capital gain subject to recapture rules.

    c. Nontaxable return of capital.

    d. Ordinary income.

28. In agriculture, a hedging transaction generally requires three basic criteria. Which of the following is ***not*** a criterion?

    a. The contract is in farm commodities produced by the farmer.

    b. The contract protects the farmer from unfavorable price fluctuations.

    c. The farmer meets identification requirements.

    d. The contract must be speculative.

29. A landlord enters into an agreement with a lessor who rents the land. The crop that is produced is shared between the two. If the landlord materially participates in the production of the crop and there is a connection between the rental income and the material participation, the landlord will report income as:

    a. A capital gain.

    b. Self-employed income.

    c. Rental income not subject to Self Employment tax.

    d. Partnership income.

30. Pete leases land he owns to Paul to grow wheat. Pete does not materially participate in the production or management. Paul delivers 10,000 bushels of wheat to Pete under their crop-share agreement. Assuming the grain is worth $3 a bushel when delivered, $4 a bushel at year-end, and $5 a bushel when Pete sells the wheat in the following year. Pete reports income of:

    a. $30,000.

    b. $40,000.

    c. $50,000.

    d. $35,000.

Lesson 3: Rental Property (Schedule E)

INTRODUCTION

It is not uncommon for taxpayers to own dwellings with both rental and personal use. The different combinations of rental and personal use are endless, and such variations may have different tax treatments. Generally, the rental income and expenses are reported on Schedule E of the individual's tax return. However, when a primary residence or any other residence is rented for fewer than 15 days during the calendar year, none of the rent is taxable, and the rental income and expenses are ignored.

When a taxpayer incurs a loss from a rental activity, several statutory obstacles must be overcome before the loss can be deducted:

1. vacation home rules,
2. hobby loss rules,
3. at-risk rules, and
4. passive activity loss rules.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:
- Allocate income and expense items for rental property also used as a personal residence.
- Describe the treatment of property converted from a residence to a rental unit and related parties in a property rental.

Residences and Vacation Homes

Tax reporting on the rental of a taxpayer's residence or vacation home depends on how many days the property is used for rental purposes as opposed to personal purposes. Rental properties used personally by the taxpayer fall into one of three categories when determining their tax treatment:

1. *Personal Residence with Very Limited Rental Use.* A residence (as defined later in this lesson) that is rented for fewer than 15 days during the year.
2. *Vacation Home with Both Rental and Personal Use.* Property with (a) personal use that exceeds the greater of 14 days or 10% of rental days *and* (b) rental use that exceeds 14 days.
3. *Rental Property with Very Limited Personal Use.* Property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days.

As the following discussion indicates, the tax treatment for the three categories differs. It is important for the practitioner to determine whether a property is a personal residence, vacation home, or a rental property with personal use under IRC Sec. 280A. The property's designation for tax purposes can change yearly, depending on how the property is used. Generally, the property's designation also impacts treatment for sale of the property.

Personal Residence with Very Limited Rental Use

A taxpayer's dwelling is treated as a residence if during the year it is used for personal purposes for more than 14 days, or more than 10% of the number of rental days if greater. Creating a trophy house used for marketing, training, and entertainment does not preclude the residence from being treated as a personal residence if the taxpayers live in it. If such residence is rented for fewer than 15 days during the calendar year, it is considered solely a personal residence. The taxpayer is not entitled to a Schedule E deduction for any expenses associated with the

rental of the property, and any income received from the rental use is not taxable. Interest expense, to the extent it is qualified residential interest expense, and real estate taxes are 100% deductible as itemized expenses on Schedule A. Effectively, the taxpayer is considered to have received tax-exempt, nonreportable income. This rule applies whether the property is the taxpayer's primary residence or any other residence. It is of significant benefit to taxpayers who rent their home for short-term events such as Mardi Gras, Super Bowl, Masters Golf Tournament, etc. It also applies to taxpayers who use a vacation home primarily for personal purposes, but rent it for fewer than 15 days during the year.

Example 3A-1 Rental for fewer than 15 days.

John and Susan own their only home on a recreational lake. During one week in July when they take their annual vacation, they rent their home to vacationers using the lake. They receive $1,500 for the week's rental of the home. Because their home is their personal residence, and it is rented for fewer than 15 days during the year, the rental income is not taxable. In addition, any rental expenses they incur are nondeductible. They are allowed to fully deduct the qualified residential interest expense and real estate taxes on Schedule A.

Under the fewer-than-15-days-rental rule, property rented for less than fair rental value is still considered as rented. In one case, the taxpayer claimed that a $1,000 per month rental received (for a portion of the year) was less than the fair rental value of their property and consequently their property had effectively not been rented. Therefore, under the previously mentioned de minimis rental rule (rental of fewer than 15 days), they should be able to exclude the "rental" payments from their gross income. The Tax Court ruled that the property had in fact been rented for the year, even though at less than fair rental value and the exclusion did not apply.

Vacation Home with Both Rental and Personal Use

If property used as a residence (as defined previously) is rented more than 14 days, deductions (other than interest, taxes, and casualty losses) are limited to the amount of the income from the property. A set of ordering rules applies in determining allowable deductions. If these ordering rules apply, the passive loss limitations are not applicable. Furthermore, the Section 183 hobby loss rules do not apply to such a residence for any year the ordering rules apply. However, the year will be taken into account as a tax year for purposes of the hobby loss five-year safe harbor rule.

When determining the number of days a dwelling unit is used for personal purposes, a taxpayer must consider the following rules in addition to days of actual personal use:

1. Personal use includes days the residence is used or rented to anyone at less than a fair rental.

2. Personal use by other owners (or members of their family) of the property is attributed to the taxpayer. Rental and usage of timeshare units are discussed later in this lesson.

3. Rental to a family member (i.e., brother, sister, spouse, ancestor, or lineal descendent) is considered personal use unless the taxpayer can establish that (a) a fair market rental rate was received *and* (b) the dwelling was used as the family member's principal residence. (See the discussion of property rented to relatives later in this lesson.)

4. If the dwelling is used under a reciprocal arrangement that allows the taxpayer to use another dwelling, the days the taxpayer rents out his own unit are counted as personal days, even if he pays rent for the use of the other dwelling.

5. Days a taxpayer spends repairing and maintaining property on a substantially full-time basis are not counted as days of personal use. Substantially full-time (determined on a daily basis) means work is done on the unit for the lesser of eight hours or two-thirds of the time the individual is present on the premises. Provided all individuals on the property who are capable of working do work on the unit on a substantially full-time basis, use by other individuals or family members (e.g., children) not capable of such work is disregarded during a period of repair and maintenance.

If a taxpayer rents or tries to rent a personal residence for 12 or more consecutive months, the use of the home as the taxpayer's principal residence in the tax year the rental period begins or ends is not counted as personal use for

the vacation home rules. This 12-month period is known as a qualified rental period. A period of less than 12 months can also be a qualified rental period if it begins during the tax year and ends with the sale or exchange of the dwelling.

Example 3A-2 Use as a home before or after renting.

On February 28, 2008, after Mike accepted a job in New York, he and Jane moved out of a house in Dallas that had been their home for six years. From March 15, 2008 to June 30, 2009, they rented out their house in Dallas at fair rental value. Mike and Jane moved back into their house in Dallas on July 15, 2009.

Mike and Jane's use of the house as their principal residence from January 1, 2008 to February 28, 2008, and from July 15, 2009 to December 31, 2009, does not count as personal use for purposes of the vacation home rules (i.e., their use does not cause the property to be treated as a vacation home for 2008 and 2009). Therefore, no proration of expenses is required for the rental period, and rental expenses are not limited to gross rental income.

The property is a qualified personal residence for the periods Mike and Jane occupied the residence and a rental real estate activity (subject to the passive loss rules) during the rental period.

Example 3A-3 Rental to family member treated as personal use.

During the tax year, Dave and Kristy use their lake cabin for 7 days. They rent the cabin at fair rental value to other individuals for 60 days and to their son, Luke, for 28 days. Even though Luke paid fair rental value, his usage is considered personal use by Dave and Kristy because he is their son, and it is not his principal residence. Therefore, Dave and Kristy's personal use for the tax year is 35 days (7 days plus 28 days), which exceeds the greater of 14 days or 10% of the number of days rented (60 days $\times$ 10% = 6 days). Thus, the cabin is considered a vacation home since it is rented out more than 14 days during the tax year. It is subject to ordering rules for determining allowable deductions and to the overall net income limitation. (See following discussion.)

For allocation purposes, days rented to a family member count as days rented, even though those days are considered personal use for determining whether the residence is a vacation home with rental income or a rental property with personal use. This distinction is important because the former (vacation home) is subject to limitation on overall loss, but not the passive loss limits, while the latter (rental property) is subject to the passive loss limitation but not the Section 280A overall loss limitation.

What Constitutes a Fair Rental? Neither the Code nor the regulations provide much help determining what is considered a fair rental for purposes of the vacation home rules. However, IRS Pub. 527 provides that a rent is not a fair rental if it is substantially less than rents charged for similar properties. Although the term substantially is not defined in the publication, it does state that the following questions should be asked when comparing properties to determine if they are similar: (1) are they used for the same purpose? (2) are they approximately the same size? (3) are they in approximately the same condition? (4) do they have similar furnishings? and (5) are they in similar locations? If the answer to any one of these questions is no, then IRS Pub. 527 states that the properties probably are not similar.

Rental Income and Expenses. Rental income and expenses from vacation homes are reported on Schedule E. Rental expenses are deductible in the following order:

1. Qualified residential interest, taxes, casualty losses, and rental expenses not attributable to operating or maintaining the dwelling (e.g., expenditures to obtain tenants, such as commissions and advertising).

2. Operating expenses (including nonqualified residential interest), except depreciation.

3. Depreciation and other basis adjustments.

When applying these rules, the expenses in the second and third categories cannot produce a taxable loss. Thus, if the deductible interest and taxes completely offset the rental income, the operating expenses and depreciation

are not deductible. Any expenses limited under this net income rule are eligible for carryforward to future years, but they remain subject to the net income limitation.

In addition to the net income limitation, any dwelling unit treated as a vacation home is subject to prorating of expenses. This prorating is required if the property is used personally to any degree, whether or not it meets the residence definition. The expenses attributable to the rental are determined based on the number of days the property is rented at a fair rental to the total days it is actually occupied during the year. The balance of the expenses are considered personal. (See Examples 3A-4 and 3A-5.)

Example 3A-4 Prorating expenses between rental and personal usage.

Frank and Alice live in Minnesota but spend each winter in Arizona. For January–April, or 120 days during the year, they rent out their Minnesota residence for $700 per month, or $2,800 per year. Using the proration formula, 32.88% (120 days/365 days) of the expenses are allocable to the rental portion of the residence. The remaining 67.12% of the expenses are personal.

Assume they incur the following expenses for the Minnesota property:

Home mortgage interest	$ 6,000
Real estate taxes	2,500
Insurance, utilities, and maintenance	3,500

The rental income and expenses would be reported as follows:

Rental income ($700 × 4)		$ 2,800
Interest expense ($6,000 × 32.88%)	(1,973)	
Real estate taxes ($2,500 × 32.88%)	(822)	(2,795)
Subtotal		5
Insurance, utilities, and maintenance ($3,500 × 32.88%, but limited to remaining income)	1,151	(5)
Taxable income (loss)		$ -0-

Because taxable income after deducting the interest and real estate tax expense is only $5, Frank and Alice can deduct only $5 of the $1,151 operating expenses allocated to the rental period. Also, they cannot deduct any depreciation expense. They can deduct the personal portion of the interest expense ($4,027), subject to qualified residential interest rules, and real estate taxes ($1,678) on their Schedule A. Operating expenses and depreciation allocable to the rental period that are not deducted in the year incurred because of the net income limitation may be carried forward to a succeeding year, subject to the net income limitation again in that year.

Periods of Vacancy. Many properties with mixed personal and rental usage have periods when the dwelling is vacant. In this circumstance, a controversy exists between the IRS and the courts as to how expenses are to be prorated. The IRS position is that *all* expenses are to be prorated based on the period of actual usage (i.e., occupancy), whereas the courts have allowed taxpayers to prorate expenses attributable to the entire year (e.g., taxes and interest) over the full 365 days, since they accrue ratably throughout the year. The IRS position results in a greater allocation of interest and taxes to rental use, which reduces the taxpayer's deduction for operating expenses.

Example 3A-5 Prorating rental and personal expenses during periods of vacancy.

Marjo and Scott own a Montana ski villa, which they occupy personally for one month of the year and rent for three months of the year. Thus, the property is actually used for a total of four months. The remaining eight months, the property is vacant. Rental income is $16,000; expenses and depreciation for the full year are as follows:

Real estate taxes	$ 3,500
Interest expense	14,000
Maintenance and utilities	4,800
Depreciation	12,000

The controversy between the IRS and the Tax Court is illustrated by the following rental calculation:

	IRS Position	Tax Court Position
Rental income	$ 16,000	$ 16,000
Deductions:		
Taxes and interest:		
IRS: $17,500 × 3/4	(13,125)	
Tax Court: $17,500 × 3/12		(4,375)
Other expenses:		
Maintenance and utilities: $4,800 × 3/4 (limited to net rental income)	(2,875)	(3,600)
Depreciation: $12,000 × 3/4 (limited to net rental income)	—	(8,025)
	$ -0-	$ -0-

In either case, Scott and Marjo report zero net income on their Schedule E for this rental property. However, under the IRS position, the rental activity has consumed $13,125 of their tax and interest deductions, leaving only $4,375 available as itemized deductions on Schedule A. Conversely, under the Tax Court position, only $4,375 has been consumed, leaving $13,125 deductible on Schedule A. The interest expense allocable to personal use is not deductible unless it meets the definition of qualified residence acquisition debt or home equity debt.

Rental Property with Very Limited Personal Use

If the taxpayer's dwelling is rented during the tax year and personal use does not exceed the greater of (1) 14 days, or (2) 10% of rental days, it is not considered a residence. Instead, it is considered a rental property. Accordingly, no ordering tiers exist for claiming deductions, and the rental expenses are not limited to the gross rental income of the property. However, deductions must be allocated to the period of personal use, and the property is potentially subject to the hobby loss, passive activity loss, and at-risk limitations. Furthermore, the Schedule A mortgage interest deduction is lost (for the nonrental portion) because the property does not qualify as a residence.

Example 3A-6 The 14-day personal-use test.

David and Mary own a condominium in Florida, which they personally use for two weeks in February. The remainder of the year (i.e., for 351 days) it is rented. Because they do not use the dwelling for personal purposes for more than 35 days (the greater of 14 or 10% of the rental days) during the year, it is not considered their residence and the net income limitation does not apply. However, expenses must be prorated to remove the portion attributable to the personal days. Under these facts, 14/365 of each expense is not allowable on Schedule E as rental property expense. Any property taxes attributable to the personal portion are deductible on Schedule A as an itemized deduction. The mortgage interest attributable to personal use would not be deductible since David and Mary did not use the property more than 14 days. If the property was vacant for part of the year (when neither personal nor rental use occurred), a hybrid prorated computation would apply, as discussed in Example 3A-5.

Conversely, in some situations, even a single day of personal use can result in losing tax deductions. For example, if a dwelling is vacant but held out for rent for an entire year, all expenses are deductible since the property is held for the production of income. IRC Sec. 280A does not apply, since there is no personal use of the dwelling. However, if the owner were to spend a single personal day at that dwelling, all the expenses would become nondeductible personal expenses. IRC Sec. 280A(e) limits expenses attributable to renting a dwelling unit based on the days used for rental activity relative to total days the dwelling is used. (This applies whether or not the taxpayer used the dwelling as a residence.) If the dwelling is used a single day during the year for personal use, the fraction of the expenses attributable to the rental activity would be 0 (0 rental days divided by 1 day of use). Furthermore, as noted earlier, interest that is not allocated to the rental activity would not qualify as home mortgage interest since the dwelling was used only one day.

Conversion from Vacation Home to Rental Property

Since the Section 280A limitations are computed on an annual basis, it is possible for the same home to be treated as a vacation home one year and as a rental property with personal use the next. Any limited expenses related to the vacation home that were carried forward may be used in the year the residence is treated as a rental property. These carryforward expenses are still limited to the amount of income received from the property in the current year.

Example 3A-7 Conversion from vacation home to rental property.

Alice has a beach home. During 2008, she vacationed in it during April and September and rented it to unrelated parties at $2,000/month (FMV) for the remaining 10 months. She reported the following income and expenses on her 2008 return:

	Total	Schedule A	Rental	Carryforward	Nondeductible
Income	$ 20,000 [a]	$ —	$ 20,000	$ —	$ —
Mortgage Interest	(15,000) [b]	(2,466)	(12,534)	—	—
Property Tax	(4,000) [b]	(658)	(3,342)	—	—
Utilities	(7,000) [b]	—	(4,124) [c]	(1,725) [c]	(1,151)
Depreciation	(8,000) [b]	—	— [c]	(6,685) [c]	(1,315)
Net Loss	$ (14,000)	$ (3,124)	$ -0-	$ (8,410)	$ (2,466)

Notes:

[a] $2,000 × 10 months.

[b] Prorated based on 60 days personal use and 305 days rental use.

[c] Limited to gross income from the property. Remainder is allowed as a carryforward.

In 2009, Alice did not vacation at the property and rented it for 3 months to unrelated parties. Since Alice did not use the property more than the greater of 14 days or 10% of total property use, the property is treated as a rental property subject to the passive loss limitations. Her Modified AGI is less than $100,000 and she lives close enough to the property to actively participate in its rental. In computing her 2009 net income from the property, her 2009 return reflects the following:

	2009 Amount	2008 Carryforward	2009 Schedule E
Income	$ 6,000 [a]	$ —	$ 6,000
Mortgage Interest	(14,800) [b]	—	(14,800)
Property Tax	(4,300) [b]	—	(4,300)
Utilities	(2,500) [b]	(1,725)	(4,225) [b]
Depreciation	(8,000)	(4,275) [c]	(12,275)
Net Loss	$ (23,600)	$ (6,000)	(29,600)
Passive Limitation			4,600 [d]
Allowable Loss			$ (25,000)

Notes:

[a] $2,000 × 3 months.

[b] Since Alice did not use the property in 2009, 100% is allocable to rental use.

[c] Limited to gross income from the property. Remainder is allowed as a carryforward.

[d] Maximum loss allowed under IRC Sec. 469(i) is $25,000.

In 2010, Alice will have 2 separate carryforwards from 2008 and 2009. She will have depreciation carryforward from 2008 of $2,410 ($6,685 − $4,275 allowed in 2009) subject to the Section 280A limitations, and passive loss carryforward from 2009 of $4,600, subject to the Section 469 passive loss limitations.

Example of Sale of Residence Used as Both a Vacation Home and Rental Property

As the classification of a residence as vacation or rental is determined on a year-by-year basis, historical record-keeping becomes very important in tracing the tax consequences of a sale of a residence that has been used for both vacation property and rental property over many years, as illustrated in the following example.

Example 3A-8 Sale of residence for which IRC Sec. 280A applies.

Kristen purchased a home on the coast of Maine in 2006 for $640,000. She sold the property in 2009 for $540,000, thus incurring a loss of $100,000 before considering any adjustments to the basis for depreciation. During those years, she used the home for personal use as well as rental property, as reflected by the following schedule:

Year	Personal Use Days	Rental Days	Total Usage
2006	10	44	54
2007	31	45	76
2008	32	44	76
2009	7	7	14
Total	80	140	220

In 2006, she incurred a $37,000 rental loss on the property, including $12,000 of depreciation. The rental activity loss was reported on her Schedule E, but was suspended as a passive loss. This loss has not been used and has carried forward to 2009. For 2007 and 2008, other than the prorata portion of mortgage interest and real estate taxes (shown on her Form 1040, Schedule A), no loss was allowed on Kristen's tax returns because her personal days exceeded 14 days in each year. Any deductions in excess of rental income are suspended and carry forward to use against future gross income from the property. Disallowed losses for 2007 and 2008 include depreciation on the property of $16,000 for each year. Before she sold the property in March 2009, Kristen collected $1,400 of rental income for one week. She paid interest and taxes of $9,000 and other expenses related to the property of $2,500 in 2009.

When the use of property has been mixed between personal use and business use, there is a well-established pattern of allocating the sale and adjusted basis between personal and business use. (See IRS Publication 544, "Sale or Other Dispositions of Assets.") There is, however, no set method of allocating the transaction between personal and business use. The most common method would be to base the allocation on relative square footage, but this has no application to rental and vacation use. However, using the precedence of IRC Sec. 280A(c)(4)(C), the transaction can be allocated based on time used for personal versus rental. Kristen had used the property for rental purposes 140 days (63.6%) and personal 80 days (36.4%).

The business portion of the basis of the residence is reduced only to the extent a deduction is allowed under the vacation home rules. Because the $16,000 of annual depreciation calculated in both 2007 and 2008 were not allowed under the Section 280A ordering rules, the basis was not decreased for these amounts.

The tax consequences of Kristen's property sale in 2009 are as follows:

1. Kristen reports a loss on the sale of $51,600 (on Form 4797):

Sales price: $540,000 × 63.6%	$ 343,440
Original cost: $640,000 × 63.6%	$ 407,040
Less depreciation:	$ 12,000
Basis of property prior to sale:	$ 395,040
Loss:	$ 51,600

2. Since the property has been entirely disposed of in a fully taxable transaction, the passive loss of $37,000, which has carried forward, would be allowed on her Schedule E.

3. Finally, Kristen should report the $1,400 of rental income reduced by $1,400 of interest and taxes on her Schedule E. The remainder of the interest and taxes would be reported on her Schedule A as personal itemized deductions. [During 2009, the property was not used personally for more than 14 days, and also did not achieve over 14 days of rental use (seven days of each before the sale of the property in 2009). Without any guidance relating to these rules in the year of a sale, and with the 50%-50% mix of personal and rental in 2009, the logical approach is to continue to apply the limit on deductions under IRC Sec. 280A(c)(5).]

Renting a Portion of a Residence

When a taxpayer rents a portion of the dwelling unit used as his or her residence, the rules for deducting rental expenses generally depend on whether the property constitutes a single dwelling unit or multiple dwelling units. For example, if the taxpayer owns a duplex, with half used exclusively as a personal residence and the other half used exclusively for rental purposes (and assuming that each half has a separate entrance and no common-use areas), the Section 280A residential rental limitations on deductions do not apply to the rental unit. Conversely, a residence with mixed personal and rental use faces the restrictions of IRC Sec. 280A.

Example 3B-1 Dual personal and rental use.

Joe owns a four-bedroom house, using one bedroom himself, renting one bedroom to his sister at 75% of FMV, and renting the other two bedrooms at 100% of FMV to fellow college students, both of whom are unrelated parties. Joe and his three tenants all have access to the common areas of the house.

The two bedrooms that are rented to unrelated parties at FMV are treated as separate dwelling units under Prop. Reg. 1.280A-1(c)(2). The common areas, Joe's bedroom, and the room rented to his sister at less than FMV are a single dwelling subject to the residential rental limitations of IRC Sec. 280A. (See previous discussion.) Since Joe lives in the home, he automatically fails the 14-day/10% test.

Since the two rooms rented at FMV are treated as a separate dwelling unit, an allocable share of expenses (mortgage interest, real estate taxes, utilities, maintenance, and depreciation) is fully allowable against rental income, subject to the passive loss limitations. The rent received from his sister is subject to the Section 280A limitations. An allocable share of interest and taxes is allowed against the rental income. The allocable share of other rental-related expenses (such as utilities, maintenance, and depreciation) is then allowed only to the extent of any remaining net rental income from his sister. (See Example 3A-4.) The rental use allocation percentage may be determined using any reasonable method (e.g., the ratio of the square footage of the three rented rooms to total square footage). Expenses allocable to the common areas are not deductible. The balance of Joe's taxes and interest (to the extent it is qualified residential interest) can be deducted on Schedule A.

Description	Total	Common Areas	Joe's Bedroom	Sister's Bedroom	Unrelated Parties' Bedroom
Sq. Feet	2,500	1,600	300	200	400
Rental Income	$6,600[a]			$1,800	$4,800[a]
Expenses:[b]					
Mortgage Interest	(10,000)	(6,400)	(1,200)	(800)	(1,600)
Real Estate Taxes	(4,000)	(2,560)	(480)	(320)	(640)
Net Income after Interest and Taxes				680	
Utilities and Operating Expenses	(6,000)	(3,840)	(720)	(480)	(960)
Net Income before Depreciation				200	

Description	Total	Common Areas	Joe's Bedroom	Sister's Bedroom	Unrelated Parties' Bedroom
Depreciation Allowance	(12,000)[c]	N/A	N/A	(200)[d]	(1,920)
Net Loss Reported on Schedule E (before passive limitations)				-0-	(320)
Mortgage Interest Reported on Schedule A		(7,600)[e]			
Real Estate Taxes Reported on Schedule A		(3,040)[e]			

Notes:

[a] Rental income based on $200/month from unrelated parties and $150/month from sister.

[b] Expenses are being allocated based on square footage of house.

[c] Depreciation that could be claimed if entire house was actually rented.

[d] Computed depreciation of $960 limited to $200 by IRC Sec. 280A.

[e] Total of common areas and Joe's bedroom.

All structures and other property appurtenant to a dwelling unit are considered part of the unit. Property is appurtenant to a dwelling unit if it is directly related to it although not an essential part of it or attached to it. For example, an individual who rents to another person space in a garage which is appurtenant to a house in which the individual occupies as a residence is subject to the Section 280A limitations on deductions attributable to the rental because the garage is appurtenant to the dwelling unit. On the other hand, an apartment *over* a garage is, presumably, a separate dwelling structure not appurtenant to the residence, so rental of the apartment is not subject to the net income limitations.

A special exception holds that the dwelling unit limitations do not apply to that portion of a property used exclusively as a hotel, motel, or similar establishment. Property partially used as a personal residence will qualify for this exception if two tests are met:

1. the property is regularly available for occupancy by paying customers, and

2. no person having an interest in the property uses the business portion as a residence during the year.

This exception applies to a motel, where one portion of the property is residential and another is used exclusively for occupancy by paying customers. This exception also applies to inns, bed-and-breakfast properties, and the portion of a home used exclusively for rental.

Example 3B-2 Hotel exception for bed-and-breakfast activity.

Ludwig and Hilda purchased a home and renovated it for use as a bed-and-breakfast. Approximately 50% of the square footage of the three-story home is occupied by Ludwig and Hilda, while the other 50% is available to the public on a year-round basis for short-term lodging and dining purposes and is advertised as such. Ludwig and Hilda do not use any of these guest rooms or dining rooms personally. Accordingly, the Section 280A restrictions on deductibility do not apply to that portion of the home used exclusively for the bed-and-breakfast activity. However, expenses for the care and maintenance of common areas and the exterior of the building do not fall under this exception (i.e., are subject to the net income limitation).

SELF-STUDY QUIZ

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

34. For tax purposes, the definition of a vacation home with both rental and personal use is a home that:

    a. Is rented more than 14 days and used personally more than the greater of 14 days or 10% of rental days.

    b. Is rented less than 15 days and used personally less than the greater of 14 days or 10% of rental days.

    c. Is rented more than 14 days and used personally less than the greater of 14 days or 10% of rental days.

    d. Is rented less than 14 days.

35. Following the tax court position on the deduction for property tax for a vacation home with both rental and personal use, a taxpayer who pays $1,825 in taxes and uses the home 30 days for personal purposes and 60 days for rental purposes may deduct what amount of taxes in determining net rental income?

    a. $150.

    b. $300.

    c. $608.

    d. $1,825.

36. Mark owns a home that was used 30 days for personal purposes and 30 days for rental purposes. The rental income was $3,600. Expenses related to the home were: property taxes $3,650 and utilities $3,000. What is Mark's net rental income from the property based on the tax court position?

    a. $275.

    b. $1,800.

    c. $3,600.

37. Which of the following expenses related to a vacation home is deductible partially on Schedule E and partially on Schedule A?

    a. Interest.

    b. Maintenance.

    c. Depreciation.

    d. Insurance.

38. If property used as a residence and also used as rental property is used 30 days as rental property and 30 days as a personal residence, the deduction fractions for interest allocation allowed by the courts and the IRS may be summarized as follows:

	IRS	Courts
a.	30/365	30/365
b.	30/365	½
c.	½	30/365
d.	½	½

39. Jill owned a home in which she lived in for only 10 days during the year and rented it out for 355 days. Jill had rental income of $12,000; mortgage interest expense of $3,650; and insurance expense of $3,650. What amount can Jill deduct on Schedule E and Schedule A?

	Schedule E	Schedule A
a.	$7,300	$0
b.	$7,100	$200
c.	$7,100	$100
d.	$7,100	$0

40. Ed owns property that is used 80% of the year as rental property and 20% for personal use. Because of the limit on the deductibility of depreciation on vacation homes, Ed was not able to deduct any of the $5,000 depreciation for 2009. What amount of depreciation may Ed carry forward?

    a. $0.

    b. $1,000.

    c. $4,000.

    d. $5,000.

41. Rose owns a two-bedroom house, using one bedroom herself and renting the other all year at 100% of FMV. There are five rooms in the house, including three common areas. Which of the following statements is true regarding the house?

    a. 50% of all expenses are deductible in arriving at net rental income.

    b. Only the expenses allocated to the one rental room are deductible.

    c. No rental expenses are deductible and no rental income is taxable.

    d. 80% of all expenses are deductible in arriving at net rental income.

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.)**

34. For tax purposes, the definition of a vacation home with both rental and personal use is a home that: **(Page 65)**

    a. Is rented more than 14 days and used personally more than the greater of 14 days or 10% of rental days. [This answer is correct. This is the definition of a vacation home per the Internal Revenue Code. Because the home is used personally for more than 14 days, deductions are limited.]

    b. Is rented less than 15 days and used personally less than the greater of 14 days or 10% of rental days. [This answer is incorrect. If a home is rented less than 15 days, it is considered a personal residence with very limited rental use for the year per the Internal Revenue Code.]

    c. Is rented more than 14 days and used personally less than the greater of 14 days or 10% of rental days. [This answer is incorrect. If a home is used personally for not more than the greater of 14 days or 10% of rental days, it is considered rental property with very limited personal use per the Internal Revenue Code.]

    d. Is rented less than 14 days. [This answer is incorrect. If a home is rented less than 15 days, per the Internal Revenue Code, it is considered a personal residence with very limited rental use.]

35. Following the tax court position on the deduction for property tax for a vacation home with both rental and personal use, a taxpayer who pays $1,825 in taxes and uses the home 30 days for personal purposes and 60 days for rental purposes may deduct what amount of taxes in determining net rental income? **(Page 65)**

    a. $150. [This answer is incorrect. The portion of the $1,825 paid in taxes should be prorated to the rental period based on rented days to 365 days. This answer uses personal days instead of the number of rented days.]

    b. $300. [This answer is correct. The tax court position is to allocate the interest and taxes based on the ratio of rental days to 365 days. (60/365) × $1,825 = $300.]

    c. $608. [This answer is incorrect. The allocation of taxes, based on the tax court, is not based on the ratio of personal to rental use.]

    d. $1,825. [This answer is incorrect. The property taxes paid must be prorated between personal and rental use.]

36. Mark owns a home that was used 30 days for personal purposes and 30 days for rental purposes. The rental income was $3,600. Expenses related to the home were: property taxes $3,650 and utilities $3,000. What is Mark's net rental income from the property based on the tax court position? **(Page 65)**

    a. $275. [This answer is incorrect. In determining rental expense, Mark may deduct property taxes on a ratio based on number of days rented in a year.]

    b. $1,800. [This answer is correct. The ratio for deducting property taxes is 30/365 and for utilities the ratio is 30/60.]

    c. $3,600. [This answer is incorrect. This answer choice does not deduct any of the expenses. The IRS allows a prorate deduction.]

37. Which of the following expenses related to a vacation home is deductible partially on Schedule E and partially on Schedule A? **(Page 65)**

    a. Interest. [This answer is correct. Interest expense and real estate taxes are deductible on Schedule E to the extent the expense relates to the rental period and on Schedule A to the extent the expense relates to the personal use period.]

    b. Maintenance. [This answer is incorrect. Maintenance expense related to personal use property is not deductible on Schedule A per the IRS.]

    c. Depreciation. [This answer is incorrect. Depreciation is only deductible when it is related to income producing property.]

    d. Insurance. [This answer is incorrect. Insurance expense related to personal use property is not deductible on Schedule A per the IRS.]

38. If property used as a residence and also used as rental property is used 30 days as rental property and 30 days as a personal residence, the deduction fractions for interest allocation allowed by the courts and the IRS may be summarized as follows: **(Page 65)**

	IRS	Courts
a.	30/365	30/365. [This answer is incorrect. The IRS and the courts do not agree on the proper allocation of interest expense.]
b.	30/365	½. [This answer is incorrect. This answer choice does not properly reflect the positions of the tax courts and the IRS as related to the allocation for interest expense.]
c.	**½**	**30/365. [This answer is correct. The IRS position is that interest and taxes are allocated based on periods of actual usage, whereas the courts have allowed taxpayers to prorate expenses attributable to the entire year over the full 365 days. The IRS position results in a greater allocation to rental use.]**
d.	½	½. [This answer is incorrect. The IRS and the courts differ on how interest and taxes are allocated.]

39. Jill owned a home which she lived in for only 10 days during the year and rented it out for 355 days. Jill had rental income of $12,000; mortgage interest expense of $3,650; and insurance expense of $3,650. What amount can Jill deduct on Schedule E and Schedule A? **(Page 65)**

	Schedule E	Schedule A
a.	$7,300	$0 [This answer is incorrect. Expenses must be allocated between the periods of personal and rental use.]
b.	$7,100	$200 [This answer is incorrect. Mortgage interest is only deductible on Schedule A if the property qualifies as a residence.]
c.	$7,100	$100 [This answer is incorrect. Insurance and interest are not deductible on Schedule A under this scenario.]
d.	**$7,100**	**$0** **[This answer is correct. Expense must be allocated, but interest is not deductible for the nonrental portion since the property is not a "residence." Insurance is not an itemized deduction.]**

40. Ed owns property that is used 80% of the year as rental property and 20% for personal use. Because of the limit on the deductibility of depreciation on vacation homes, Ed was not able to deduct any of the $5,000 depreciation for 2009. What amount of depreciation may Ed carry forward? **(Page 65)**

    a. $0. [This answer is incorrect. Ed may carry forward depreciation allocable to the rental property per the Internal Revenue Code.]

    b. $1,000. [This answer is incorrect. This answer does not properly reflect the amount that may be carried forward as it bases the ratio incorrectly.]

    c. $4,000. [This answer is correct. The 80% rental portion is carried forward since none of the amount was deducted in 2008 per the Internal Revenue Code.]

    d. $5,000. [This answer is incorrect. The amount of depreciation carried forward must be allocated between rental property and personal use per the Internal Revenue Code.]

41. Rose owns a two-bedroom house, using one bedroom herself and renting the other all year at 100% of FMV. There are five rooms in the house, including three common areas. Which of the following statements is true regarding the house? **(Page 72)**

    a. 50% of all expenses are deductible in arriving at net rental income. [This answer is incorrect. The rental bedroom is treated as a separate dwelling unit per an IRS proposed regulation and does not represent 50% of the area of the home.]

    b. Only the expenses allocated to the one rental room are deductible. [This answer is correct. Only the bedroom being rented is considered the dwelling unit per an IRS proposed regulation. Hence only the expenses related to one room are deductible.]

    c. No rental expenses are deductible and no rental income is taxable. [This answer is incorrect. Rental income must be reported and an allocated amount of expense is deductible since a portion of a residence is rented per an IRS publication.]

    d. 80% of all expenses are deductible in arriving at net rental income. [This answer is incorrect. 80% of all expenses are not deductible. Only expenses related to the separate dwelling unit are deductible.]

The Conversion of a Residence to Rental Property

Taxpayers may decide to permanently convert a personal residence to rental property. Questions then arise as to the property's basis, when the property was placed in service, which depreciation methods to use, and how to determine gain or loss on a subsequent sale.

Generally, when a dwelling is used as a personal residence and rented in the same year, the owner must determine whether it is a vacation home or a rental property with personal use. Generally, personal use of the home for more than the greater of 14 days or 10% of the days the dwelling is rented results in it being classified as a vacation home subject to the Section 280A net income limit on deducting expenses.

However, if the rental period is a qualified rental period (generally a period of at least 12 months, starting or ending in the tax year and during which the property is rented or held out for fair rent), any personal use is ignored in determining the dwelling's status for that year (see Example 3A-2). Absent this exception, a dwelling would almost always be subject to the Section 280A limitations in the year it is converted to or from a rental property because the owner's personal use days exceed the greater of 14 or 10% of the days rented.

Depreciating a Converted Residence

When a personal asset is converted to business use (or for use in the production of income), its basis *for depreciation* is the lower of:

1. the adjusted basis on the date of conversion, or

2. the FMV of the property at the time of conversion.

Example 3C-1 Lower of cost or market value for depreciable basis.

John purchased a home in Boston in 1996 for $250,000, of which $50,000 represented the cost of the land. John lived in the home until 2009 when he moved to New York and rented out the property. The FMV of the property, excluding the land, upon its conversion to rental property was $185,000. John's basis for depreciation is $185,000, the FMV at the time of conversion, since it was less than the adjusted basis. [Adjusted basis is generally the cost of the property plus amounts paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes.

Property converted from residential to rental use must be depreciated using the method and recovery period in effect in the year of conversion. The method that applied in the year the property was originally acquired is irrelevant. Thus, a home converted from personal to rental use during 2009 is depreciated over 27.5 years (39 if the rental is not residential) under MACRS.

Reporting Gain or Loss on the Sale of a Converted Residence

If the converted property is later sold at a gain, the basis in the converted property is the original cost or other basis plus amounts paid for capital improvements, less any depreciation taken. If the sale results in a loss, however, the starting point for basis is the lower of (1) the property's original cost or other basis or (2) FMV at the time it was converted from personal to rental property. This rule is designed to ensure that any decline in value occurring while the property was held as a personal residence (i.e., before conversion to rental property) does not later become deductible upon sale of the rental property. Thus, a loss from the sale of converted property is allowed only to the extent the property has declined in value following the conversion and taking into account any depreciation allowed or allowable.

Example 3C-2 Determining gain or loss on sale of converted property.

Jane converted her personal residence to income-producing property eight years ago. The house originally cost $50,000. Its FMV was $60,000 when it was converted to rental use. Over the eight-year rental period, assume that a total of $9,000 in depreciation was taken. In 2009, Jane sold the property for $65,000. The gain is computed as follows:

(1) Original cost	$ 50,000
(2) Conversion value	60,000
(3) Depreciation taken	9,000
(4) Adjusted basis for determining gain (1 − 3)	41,000
(5) Adjusted basis for determining loss [(lesser of 1 or 2) − 3]	41,000
(6) Sales price	65,000
(7) Realized gain (6 − 4)	$ 24,000

How would this conclusion change if the property's FMV at conversion was $45,000 rather than $60,000, the total depreciation taken was $8,000 rather than $9,000, and the sales price was $40,000 instead of $65,000? The loss would be computed as follows:

(1) Original cost	$ 50,000
(2) Conversion value	45,000
(3) Depreciation taken	8,000
(4) Adjusted basis for determining gain (1 − 3)	42,000
(5) Adjusted basis for determining loss [(lesser of 1 or 2) − 3]	37,000
(6) Sales price	40,000
(7) Realized gain, if any (6 − 4)	$ -0-
(8) Realized loss, if any (6 − 5)	$ -0-

No reportable gain or loss occurs because (1) no gain results when the original cost is used in the gain computation, and (2) no loss results when using the lower of cost or market basis for determining loss. As this example illustrates, the rules for determining gain or loss will result in neither if the sales price falls between the basis amounts used to calculate each.

Renting Property to Related Parties

Property Rented to a Family Member or Joint Owner

For determining a dwelling's status [i.e., vacation home or rental property with personal use], a taxpayer's personal use of the dwelling generally includes use by a family member (i.e., brother, sister, spouse, ancestor, or lineal descendent). This is true even if the family member pays a fair rental price. However, a family member's use is not attributed to the owner if the family member pays a fair rental price and uses the dwelling as a principal residence.

Example 3D-1 Rental at fair value to family member.

Gus owns a house that he rents to his son, Jake. Jake has no ownership interest in the property, uses it as his principal residence, and pays Gus a fair rental price for the property.

Under IRC Sec. 280A(d)(3), Jake's use of the house is not considered personal use by Gus because Jake uses it as a principal residence, he has no interest in the property, and he pays a fair rental price. The house is considered a rental property, so any rental loss incurred is deductible by Gus, subject to the hobby loss, at-risk, and passive activity loss rules. The vacation home rules do not come into play.

Example 3D-2 Rental at less than fair value to family member.

Dave rents a house to his mother at less than a fair rental price. She uses the house as her principal residence. In this situation, Dave is considered to use the house for personal purposes on the days his mother rents the property because she pays less than a fair rent. The rent house is thus considered Dave's vacation home under IRC Sec. 280A so rental deductions are subject to income limitations.

Taxpayers may argue that rental to a relative at a discount from what would be charged to an unrelated party is a FMV rent, since the relative is a better and more reliable tenant and the owner can avoid agency management fees. In *Bindseil*, the Tax Court held that such reasoning did justify a 20% discount off market rental value. While this

argument may have merit, taxpayers who maintain such a position should be able to substantiate such claims with objective data (e.g., a discount equal to agency fees that would otherwise be incurred).

Property Rented to a Related Business

Individuals sometimes rent real estate, equipment, and other property to business entities they own. A common type of arrangement is renting property to a closely held corporation or S corporation.

Renting property to a closely held corporation is an effective way for taxpayers to draw money out of the business in a form other than wages (which are subject to payroll tax) or corporate distributions, which are taxable to shareholders to the extent of corporate earnings and profits (E&P) and are not deductible by the corporation. However, rental amounts that are too high risk possible reclassification as dividends or compensation. On the other hand, taxpayers that receive too little or no rent for property used by their closely held corporation may be in constructive receipt of rental income.

Example 3D-3 Renting home office space to an S corporation.

Brooke and her daughter, Linda, age 31, own all the stock of BLC Inc., an S corporation. To shift some corporate income to Linda, BLC enters into a lease with her for both an office and a storage area in her home. These spaces are used by the S corporation for its business activities and by Linda to perform her duties as an employee. Based on a local property management firm's analysis, Brooke and Linda determine that a reasonable rent for this space is $12,000 per year. Thus, BLC will pay $12,000 of deductible rent to Linda, who will report $12,000 of rental income on her individual tax return. Because she is BLC's employee, she cannot claim any deductions for the rental activity. Still, as rental income, the payments are not subject to SE tax or payroll taxes.

In the case of family farm corporations, it is common for the business entity to provide lodging to shareholder-employees. This is a common practice because the business needs require the employees to reside at the premises of the farming activity. However, an arrangement may exist whereby the residence continues to be owned personally rather than by the corporation, and thus is leased by the individual to the corporation. In these situations, IRC Sec. 280A(c)(6) prohibits claiming any deductions (other than interest or taxes) in connection with the rental of the taxpayer's residence to an employer during any period in which the taxpayer uses the residence in performing services as an employee. And in *Dobbe*, the court found that the owner of a farming corporation could not convert personal expenses to deductible business expenses by leasing his residence (located on a farm) to the corporation and adopting a corporate resolution requiring the shareholder/employees to live on the premises. Also, leasing a residence to the employer's farm corporation results in losing the ability to exclude gain on the sale of the residence under IRC Sec. 121, if it causes the owner to fail the two-out-of-five-year use-as-a-personal-residence requirement.

SELF-STUDY QUIZ

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

42. Jackie converted property from personal use to business use. Later, Jackie sold the property at a loss. Jackie's basis for computing the loss (ignoring capital improvements and depreciation) is:

    a. Basis on the date of conversion.

    b. FMV on the date of conversion.

    c. The higher of the basis or FMV on the date of conversion.

    d. The lower of the adjusted basis or FMV on the date of conversion.

43. When determining a dwelling's status as either a vacation home or rental property with personal use, a taxpayer's personal use includes use by a family member. Listed below are family members. Select the answer choice that best reflects the definition of a related party for purposes of rental property.

    a. Brother, sister, or spouse.

    b. Brother, sister, spouse, ancestor, or lineal descendent.

    c. Brother, sister, spouse, nephew, or cousin.

    d. Brother, sister, spouse, niece, or lineal descendent.

44. Renting property to a closely held corporation is a way for taxpayers to obtain a draw in a form other than wages or corporate distributions. From the answer choices below, determine why this transaction is desirable.

    a. Rental payments to an owner are not deductible by the corporation.

    b. Rental amounts that are two high may be reclassified as compensation.

    c. Rental payments to an owner are not subject to payroll tax or taxation as E&P.

    d. Rental amounts that are too low may cause the owner to be in constructive receipt of rental income.

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.)**

42. Jackie converted property from personal use to business use. Later, Jackie sold the property at a loss. Jackie's basis for computing the loss (ignoring capital improvements and depreciation) is: **(Page 80)**

    a. Basis on the date of conversion. [This answer is incorrect. Using basis would ignore the reduction in the value of the property while it was personal use property.]

    b. FMV on the date of conversion. [This answer is incorrect. Using FMV would allow a taxpayer to increase the basis of a personal use asset for any appreciation in value without recognizing income.]

    c. The higher of the basis or FMV on the date of conversion. [This answer is incorrect. Using the higher of basis or FMV would allow the taxpayer to increase a loss on the sale.]

    d. The lower of the adjusted basis or FMV on the date of conversion. [This answer is correct. The lower of the adjusted basis or FMV limits the loss deduction and eliminates any benefit from converting personal use property to business use and then selling the property.]

43. When determining a dwelling's status as either a vacation home or rental property with personal use, a taxpayer's personal use includes use by a family member. Listed below are family members. Select the answer choice that best reflects the definition of a related party for purposes of rental property. **(Page 81)**

    a. Brother, sister, or spouse. [This answer is incorrect. The answer choice omits some individuals who are considered family members for purposes of determining the status of a rental property.]

    b. Brother, sister, spouse, ancestor, or lineal descendent. [This answer is correct. All family members for purposes of the Internal Revenue Code are reflected.]

    c. Brother, sister, spouse, niece, or cousin. [This answer is incorrect. Although a nephew or cousin may be a relative, they are not lineal descendents and therefore do not meet the requirements of the Internal Revenue Code.]

    d. Brother, sister, spouse, niece, or lineal descendent. [This answer is incorrect. This answer choice improperly includes one type of relative as a family member and omits another. Therefore, the answer choice does not meet the definition of family member for purposes of determining rental property status.]

44. Renting property to a closely held corporation is a way for taxpayers to obtain a draw in a form other than wages or corporate distributions. From the answer choices below, determine why this transaction is desirable to an owner. **(Page 81)**

    a. Rental payments to an owner are not deductible by the corporation. [This answer is incorrect. Rental payments to an owner are deductible by the corporation as an ordinary business expense. However, this is not the reason why the owner would want to rent property to the corporation.]

    b. Rental amounts that are too high may be reclassified as compensation. [This answer is incorrect. While it is true that rental payments that are too high may be reclassified as compensation (especially under the S Corp rules), this is not the reason why a business owner would want to rent property to the corporation.]

    c. Rental payments to an owner are not subject to payroll tax or taxation as E&P. [This answer is correct. Rental payments made to an owner by a closely held corporation would increase the cash flow of the individual owner without subjecting the owner to payroll tax or taxes on dividends.]

    d. Rental amounts that are too low may cause the owner to be in constructive receipt of rental income. [This answer is incorrect. While it is true that rental payments that are too low may be reclassified as constructive receipt of rental income (especially under the S Corp rules), this is not the reason why a business owner would want to rent property to the corporation.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TDBTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

31. For tax purposes, to be treated as a personal residence with very limited rental use, the residence:

    a. Cannot be rented to another at any time during the year.

    b. Cannot be rented for 15 days or more during the year.

    c. Cannot be rented for more than 10% of the year.

    d. Do not select this answer choice.

32. Following the tax court position on the deduction for property tax and interest for a vacation home with both rental and personal use, a taxpayer who uses the home 30 days for personal purposes and 60 days for rental purposes may deduct what fraction of taxes and interest in determining net rental income?

    a. 30/60.

    b. 30/90.

    c. 60/365.

    d. 90/365.

33. The amount of real estate taxes on property used 60 days as a residence and 60 days as rental property is $3,650. The itemized deduction for real estate tax using the IRS position is:

    a. $600.

    b. $1,825.

    c. $3,050.

    d. $3,650.

34. Which of the following statements is true for rental property when personal use does not exceed the greater of (1) 14 days, or (2) 10 % of rental days?

    a. Rental expenses are deductible, but limited to rental income.

    b. All expenses are allocated to the rental use of the property.

    c. Depreciation is not permitted.

    d. Mortgage interest allocable to the personal use portion of the year is not deductible.

35. Harmon owns a rental home in an undesirable area of town and has been unable to rent it during the year. Harmon's cousin comes to town and needs a place to stay for one night. Harmon offers the cousin the rental property and a bedroll for the night. How will Harmon's expense deductions be affected by his generosity?

    a. All expenses become nondeductible personal expenses.

    b. Any mortgage interest on the property now qualifies as home mortgage interest.

    c. The expenses are deductible using the ratio 364/365.

    d. All expenses continue to be 100% deductible.

36. Each of the following taxpayers has a case in tax court. Which taxpayer has the best chance of having tax court approval for renting a property to a relative at a price other than market retail value?

    a. Ewen rents a home to his brother for one dollar per month.

    b. Martha rents a home to her sister, Mary, at a discount equal to the rental agency fees.

    c. Ellen rents a home to her mother at a discount equal to twice the normal rental agency fees.

    d. Dagwood rents a home to his father at a discount of half of the rental market rates.

37. When property is converted from a personal asset to business use, its basis for depreciation purposes is:

    a. Adjusted basis on the date of conversion.

    b. FMV on the date of conversion.

    c. The lower of adjusted basis or FMV on the date of conversion.

    d. The higher of basis or FMV on the date of conversion.

38. In 2005, Willie converted a personal residence into income-producing property. The house cost $110,000 and was worth $90,000 on the date of conversion. Willie had taken $10,000 of depreciation since 2005. In 2009, Willie sold the property for $120,000. Willie should report:

    a. $10,000 gain.

    b. $20,000 gain.

    c. $40,000 gain.

    d. No gain or loss.

39. Which of the statements below regarding the conversion of residential property to rental use is correct?

    a. The property must be depreciated using the depreciation method which was in effect in the year the property was originally acquired.

    b. The depreciation method and recovery period in effect in the year of conversion must be used.

    c. If a home is converted to rental use from personal use during 2009, it is depreciated over 39 years under MACRS.

    d. Do not select this answer choice.

40. Select the scenario that will allow the owner of rental property to avoid having a related party's use of the property attributable to the owner.

    a. Susan owns a home along a rural river which she rents to her sister at a fair rental price.

    b. Susan's sister gets married and moves out of the river house. Susan now rents it to her mother at less than a fair rental price.

    c. Susan's mother passes away and the river house is vacant most of the year. Susan rents the home to her brother and his family for a portion of the year. The brother pays a fair rental price.

    d. Susan's son takes a job in a town near the river house. The son pays less than a fair rental price and uses the home as his principal residence.

GLOSSARY

Commodity Hedging Transaction: A hedging transaction is one entered into in the normal course of a taxpayer's business primarily to reduce the risk of: 1. price changes or currency fluctuations on ordinary property (i.e., property, the sale or exchange of which could not produce a capital gain or loss) that the taxpayer holds or will hold, or 2. interest rate or price changes or currency fluctuations on the taxpayer's ordinary obligations.

Crop-share Agreement: Farmers and other landowners often enter into crop-share arrangements in consideration for the rental of their land. The rent they receive in this kind of arrangement is based on a share of the crop or livestock produced on the land. The landowner is paid in kind with crops or livestock produced or with cash generated from their sale.

Daycare Facility Deductions: For daycare facilities, usage considers the amount of time used. Rev. Rul. 92-3 provides a formula for allocating expenses for a daycare facility. The computation allocates expenses based on square footage and number of hours of business usage. In determining the square footage of the home used for business, the ruling allows a room that is available during the day and regularly used for daycare (e.g., a bathroom) to be treated as used during every hour of the business day for daycare (even if it is not in use during every hour of the business day for business). To qualify for these special rules for the home office deduction, the daycare facility must be licensed or approved under the taxpayer's respective state laws (or exempt from these requirements)

Depreciation (for Farm Property): Property used in a farming business must be depreciated using the 150% declining balance method.

Direct Expense (Home office): Direct expenses for a home office (e.g., repairs made to the specific room used for business) are deducted in full (subject to the income limitation).

Form 4797: If an oil and gas property is disposed of at a gain, a gain is reported on Form 4797 (Sales of Business Property), Part III.

Gain on Sale of Personal Residence: Gain on Sale of Personal Residence Is reported on Form 1040, Schedule D

Hobby Loss Rules: The Internal Revenue Code "backs into" the rules governing activities not engaged in for profit (commonly referred to as "hobbies") by including all activities of the taxpayer other than those for which deductions are allowable under IRC Sec. 162 (expenses of carrying on a trade or business) or 212 (expenses incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income).

Home Office: Home office deductions are available to both self-employed taxpayers and employees. However, if the taxpayer is an employee, the business use of the home must be for the convenience of the employer, and the space must be used exclusively and regularly for job-related activities.

Intangible Drilling Costs (IDC): The regulations define IDC as any cost incurred that in itself has no salvage value and is incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. These costs include wages, fuel, repairs, hauling, and supplies.

Owner's use of rental property: Property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days.

Patron Dividends: Cooperative (co-op) patronage dividends are distributions to patrons made by a cooperative and represent an allocation of the co-op's profits. They are generally reported as income on lines 5a and 5b of Schedule F (Profit or Loss From Farming). The patronage dividend is similar to a rebate on purchases.

Percentage Depletion: The working interest owner is entitled to a deduction for the greater of cost depletion or allowable percentage depletion (sometimes referred to as statutory depletion—IRC Sec. 613A). Percentage depletion, on the other hand, is based on a percentage of gross receipts from the property.

Personal Residence with Very Limited Rental Use: A residence that is rented for fewer than 15 days during the year.

Prepaid Farming Expenses: Cash-basis farmers can deduct prepaid expenses (e.g., feed, seed, fertilizer, other similar expenses, and certain poultry expenses) to the extent the prepaid expenses are 50% or less than the deductible nonprepaid expenses for the taxable year.

Rental Property with Very Limited Personal Use: Property rented during the year and personal use that does not exceed the greater of 14 days or 10% rental days**.**

Schedule F, Form 1040: Farmers generally report income and expenses on Schedule F (Profit or Loss From Farming).

Start-up Costs: Start-up costs are expenses that would be deductible if incurred by an active trade or business, but do not include interest, taxes, or research and experimental expenditures (whose treatment is governed by other statutory provisions). They generally are segregated into two broad categories—investigatory expenses and preopening costs.

UNICAP Rules: Rules Uniform capitalization (UNICAP) rules require that direct costs and an allocable portion of indirect costs incurred in production activities be capitalized. However, many farming activities are exempt from the UNICAP rules.

Vacation Home with Both Rental and Personal Use: Property with (a) personal use that exceeds the greater of 14 days or 10% of rental days and (b) rental use that exceeds 14 days.

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COMPANION TO PPC'S 1040 DESKBOOK

COURSE 2

Personal Deductions (TDBTG092)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to the standard deduction and the itemized deduction, including the itemized deduction phase-out rules. This course covers most line items on Form 1040 Schedule A, including confusing issues such as employee business expense and interest tracing rules.

PUBLICATION/REVISION DATE: November 2009

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours
CTEC HOURS: 8 Federal, 0 California

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 course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2010**

KNOWLEDGE LEVEL: Basic

LEARNING OBJECTIVES:

Lesson 1—Standard Deduction

Completion of this lesson will enable you to:
- Calculate the additional standard deduction and the reduced standard deduction.
- Identify the relationship between itemized deductions and the standard deduction.

Lesson 2—Medical Expenses

Completion of this lesson will enable you to:
- Identify deductible medical expense.
- Calculate the deduction for medical expenses.

Lesson 3—Charitable Contributions

Completion of this lesson will enable you to:
- Calculate charitable contribution deductions.
- Identify the rules and requirements for charitable contribution deductions.

Lesson 4—Deductible Taxes

Completion of this lesson will enable you to:
- Differentiate between deductible and nondeductible taxes.

Lesson 5—Other Itemized Deductions

Completion of this lesson will enable you to:
- Determine the deduction for personal casualty losses and gambling losses.
- Identify employee job-related expenses that qualify as miscellaneous itemized deductions or other itemized deductions.

Lesson 6—Interest Expense

Completion of this lesson will enable you to:
- Describe the interest tracing rules and other rules related to interest expense.
- Calculate the deduction for various types of interest expense.
- Compute the investment interest expense deduction.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
TDBTG092 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Standard Deduction

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. For 2009, the applicable standard deductions available to individuals are as follows:

Filing Status	Standard Deduction
Joint filers and surviving spouses	$ 11,400
Head of household	8,350
Single and married filing separately	5,700

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. This is because the spouse filing as head of household is treated as unmarried for the tax 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, real property taxes, certain disaster losses, and motor vehicle sales tax. The standard deduction is reduced 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 may also elect to itemize deductions on their federal return 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.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:

- Calculate the additional standard deduction and the reduced standard deduction.
- Identify the relationship between itemized deductions and the standard deduction.

Items Related to the Additional Standard Deduction

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 2009, the additional standard deduction amounts are as follows:

Taxpayer	Amount
Age 65 or over filing jointly, as surviving spouse, or married filing separately	$ 1,100
Age 65 or over filing as single or head of household	1,400
Blind filing jointly, as surviving spouse, or married filing separately	1,100
Blind filing as single or head of household	1,400

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.

Example 1A-1 Married elderly and blind taxpayers.

Archie and Edith file jointly and do not itemize deductions. Archie is age 65 and blind with no hope of recovering his sight. Edith is also age 65. What is Archie and Edith's 2009 standard deduction?

Because Archie is both elderly and blind, he is entitled to two additional standard deductions of $1,100 each. Edith is entitled to one $1,100 additional standard deduction because she is elderly. Thus, Archie and Edith's 2009 return will reflect a standard deduction of $14,700 ($11,400 basic standard deduction plus $3,300 of additional standard deductions).

If Archie and Edith file separately, Archie would be entitled to a standard deduction of $7,900 ($5,700 basic standard deduction plus additional standard deductions of $2,200). Edith would be entitled to a standard deduction of $6,800 ($5,700 + $1,100). However, if either separately filing spouse itemizes, the other is not entitled to the basic or additional standard deductions (i.e., the other must also itemize deductions).

Local Real Property Taxes

The American Housing Rescue and Foreclosure Prevention Act of 2008 provided an addition to the basic standard deduction for certain taxpayers in 2008. Taxpayers filing single could add up to $500 of state and local real property taxes to their basic standard deduction amount. Married joint filers could add up to $1,000 to their basic standard deduction amount. However, the additional amount could not exceed the amount of state and local property taxes actually paid. The Tax Extenders and AMT Relief Act of 2008 (the 2008 Extenders Act) extended this provision through 2009. (For 2009, the additional standard deduction is noted by checking box 40b on page 2 of Form 1040 and reported on Schedule L.)

Disaster Losses

The 2008 Extenders Act allows nonitemizers in 2008 and 2009 to add their disaster loss deduction to their basic standard deduction for both regular tax and AMT purposes. A taxpayer's disaster loss deduction is the excess of personal casualty loss attributable to a federally declared disaster occurring in a disaster area before January 1, 2010, over personal casualty gains. (For 2009, the additional standard deduction is noted by checking box 40b on page 2 of Form 1040 and reported on Schedule L.)

Qualified Motor Vehicle Sales Taxes

The American Recovery and Reinvestment Act of 2009 allows taxpayers to deduct sales taxes paid on a qualified motor vehicle up to the first $49,500 of cost. The taxpayer may elect to take the deduction either as an additional

component of the standard deduction (noted by checking box 40b on page 2 of Form 1040 and reported on Schedule L) or as an itemized deduction (on Schedule A), but not both.

AMT Implications. The decision about how and where to deduct qualified motor vehicle sales taxes may impact the taxpayer's AMT liability. In computing alternative minimum taxable income (AMTI), the sales taxes are:

1. Deductible—
   - if the qualified motor vehicle sales taxes are added as a component of the standard deduction, or
   - if itemized deductions for state and local income taxes are claimed and the qualified motor vehicle sales taxes are added.
2. Nondeductible if itemized deductions include state and local general sales taxes (which include the qualified motor vehicle sales taxes).

Applying the Reduced Standard Deduction to Dependents

For taxpayers who are or can be claimed as dependents on another return, the standard deduction for 2009 is limited to the greater of (1) $950, or (2) earned income plus $300 (not to exceed the regular standard deduction). The amount is adjusted annually for inflation.

Dependent Children

The impact of the reduced standard deduction is most often felt in connection with the kiddie tax, but it applies to all dependent children, whether or not the kiddie tax applies. In effect, for 2009 a dependent child with *no earned income* can shelter only $950 of taxable income with the standard deduction. On the other hand, for 2009, a dependent child with *earned income* can shelter up to $5,700 of income, which can include no more than $300 of unearned income (e.g., $5,400 of earned income plus $300 of unearned income).

Example 1B-1 Standard deduction for dependent child with earned income.

Stewart, age 16, is a full-time student whose summer job paid him $2,500 in 2009. He also has $200 of interest income. Because Stewart is eligible to be claimed as a dependent on his parents' return, his standard deduction for 2009 is limited to $2,800 ($2,500 earned income plus $300). Accordingly, Stewart's income is less than his standard deduction so he owes no tax for 2009 and is not required to file a return.

Variation: Assume Stewart's interest income is $400 rather than $200. Here, Stewart must file a return because his standard deduction is still limited to $2,800 while his total income is $2,900 ($2,500 earned income plus $400 unearned income). Only $300 of unearned income can be sheltered in this situation, so Stewart must pay tax on $100 of income.

Earned income for this purpose includes net earnings from self-employment (e.g., Schedule C income). However, it is not reduced by a self-employment loss.

Example 1B-2 Dependent's earned income without self-employment loss.

Lana, age 17, is single and qualifies as a dependent for 2009 on her parent's tax return. She has incurred a loss from the first year's operations of her website design business. She also worked part-time at a store. Her parents have claimed her as a dependent and she wants to claim the standard deduction for 2009. She has the following income:

W-2 wages	$ 4,300
Taxable interest	8,150
Self-employment income or (loss)	(7,150)

Lana's 2009 standard deduction is limited to the greater of $950 or her earned income plus $300. Since the tax court has not considered losses from self-employment income as part of earned income for purposes of

the basic standard deduction, Lana's standard deduction is $4,600 ($4,300 earned income + $300.) If she had to take the loss from her self-employment into account, Lana's standard deduction would be $950.

Dependent Parents

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 2009 an elderly, single dependent taxpayer with no earned income can claim the $950 reduced basic standard deduction plus the $1,400 additional standard deduction for elderly single taxpayers.

Example 1B-3 Standard deduction for dependent parent.

Henry, single and age 67, is claimed as a dependent by his son. Henry earned $1,750 in 2009 from a part-time job. What is his 2009 standard deduction?

Because Henry can be claimed as a dependent on another's return, his basic standard deduction is limited to the greater of (a) $950 or (b) earned income plus $300, not to exceed $5,700. Thus, his basic standard deduction is $2,050 ($1,750 earned income plus $300). Henry can also claim an additional $1,400 standard deduction for elderly, single taxpayers. This results in a total allowable 2009 standard deduction of $3,450 ($2,050 standard deduction plus $1,400 elderly deduction).

Variation: If Henry's earned income were only $250, his standard deduction would be $2,350 (basic standard deduction of $950 plus additional standard deduction of $1,400). If he could not be claimed as a dependent by someone else, his standard deduction for 2009 would be the full $7,100 ($5,700 basic deduction plus $1,400 additional deduction).

SELF-STUDY QUIZ

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

1. Joe and Mary are married taxpayers who for the past five years have filed joint returns. For 2009 they have decided to file separate returns. If Mary were to file as head of household electing itemized deductions; how must Joe file?

   a. Single, electing itemized deductions.

   b. Single, claiming the standard deduction.

   c. Married filing separately, electing itemized deductions.

   d. Married filing separately, claiming the standard deduction.

2. Betty, age 63, and Albert, age 69, have been married for 16 years. During 2009, Betty suffered from a disease that has left her legally blind with no hopes of ever regaining her eyesight. If Betty and Albert file a joint return, how much would they claim as their standard deduction?

   a. $11,400.

   b. $12,500.

   c. $13,600.

   d. $13,800.

3. In 2007, Wanda was diagnosed with a degenerative eye disease that will leave her completely blind in two years. In order for her to receive the additional standard deduction amount in 2009, she must complete all of the following steps **except**:

   a. Wanda needs to receive a certified statement from her eye physician and attach it to her 2009 tax return.

   b. Wanda must check the appropriate boxes in the Tax and Credits section of page 2 of Form 1040 to indicate blind status.

   c. Wanda should receive a certification from a registered optometrist stating the nature of the blindness and the fact that her vision will never improve and keep it in her records.

4. Julie, age 15, is a full-time student who works part-time during the weekends. Her part-time job paid her $3,600 in 2009; she also received $100 in interest income. Julie was claimed as a dependent on her parents' 2009 tax return. Her standard deduction for 2009 is limited to:

   a. $950.

   b. $3,600.

   c. $3,700.

   d. $3,900.

5. Mark is single and 74 years old. In 2009, he earned $3,200 from his part-time job. His daughter will claim him as a dependent on her 2009 tax return. What is Mark's standard deduction for 2009?

   a. $2,350.

   b. $4,600.

   c. $4,900.

   d. $5,700.

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.)**

1. Joe and Mary are married taxpayers who, for the past five years, have filed joint returns. For 2009, they have decided to file separate returns. If Mary were to file as head of household electing itemized deductions; how must Joe file? **(Page 93)**

   a. Single, electing itemized deductions. [This answer is incorrect. A spouse is not considered a single taxpayer for the taxable year when the other spouse is filing head of household.]

   b. Single, claiming the standard deduction. [This answer is incorrect. While the spouse filing head of household is considered unmarried for the taxable year, the other spouse is still treated as married.]

   c. Married filing separately, electing itemized deductions. [This answer is correct. According to the Internal Revenue Code, married taxpayers who file separate returns must treat their deductions consistently. If the spouse who files as head of household elects to itemize, the other spouse must also itemize.]

   d. Married filing separately, claiming the standard deduction. [This answer is incorrect. Since Mary decided to file as head of household electing to itemize, Joe may not claim the standard deduction. Joe could have claimed the standard deduction if Mary had chosen to claim the standard deduction as head of household.]

2. Betty, age 63, and Albert, age 69, have been married for 16 years. During 2009, Betty suffered from a disease that has left her legally blind with no hopes of ever regaining her eyesight. If Betty and Albert file a joint return, how much would they claim as their standard deduction? **(Page 93)**

   a. $11,400. [This answer is incorrect. This amount represents the standard deduction for a joint return for 2009 assuming neither spouse is either 65 or older or blind.]

   b. $12,500. [This answer is incorrect. This amount only takes into account one of the spouses being either older than 65 or blind.]

   c. $13,600. [This answer is correct. Because Betty is legally blind and Albert is older than 65, the couple is eligible for two additional standard deductions at $1,100 each. [$11,400 + (2 x $1,100)] = $13,600.]

   d. $13,800. [This answer is incorrect. This amount properly accounts for two additional deductions due to Betty's blindness and Albert's age; however, it incorrectly computes the two additional deductions at the amount for unmarried taxpayers. [$11,400 + (2 x $1,400)] = $13,800.]

3. In 2007, Wanda was diagnosed with a degenerative eye disease that will leave her completely blind in two years. In order for her to receive the additional standard deduction amount in 2009, she must complete all of the following steps **except**: **(Page 93)**

   a. Wanda needs to receive a certified statement from her eye physician and attach it to her 2009 tax return. [This answer is correct. According to an IRS publication, the IRS does not require an individual to attach the certified statement regarding their blindness to their tax return.]

   b. Wanda must check the appropriate boxes in the Tax and Credits section of page 2 of Form 1040 to indicate blind status. [This answer is incorrect. When Wanda files her 2009 tax return, she must mark the boxes on Form 1040 as described in IRS Pub. 17.]

   c. Wanda should receive a certification from a registered optometrist stating the nature of the blindness and the fact that her vision will never improve and keep it in her records. [This answer is incorrect. According to an IRS publication, to claim this deduction, Wanda must obtain a certified statement from an eye physician or registered optometrist, as described above. If it is determined that no reasonable possibility exists that her vision will ever improve beyond the minimum standards for claiming blindness, the certification must include this fact.]

4. Julie, age 15, is a full-time student who works part-time during the weekends. Her part-time job paid her $3,600 in 2009; she also received $100 in interest income. Julie was claimed as a dependent on her parents' 2009 tax return. Her standard deduction for 2009 is limited to: **(Page 95)**

   a. $950. [This answer is incorrect. This amount represents the standard deduction if the dependent child, Julie, had received no earned income during 2009.]

   b. $3,600. [This answer is incorrect. A dependent child's earned income does not represent his or her standard deduction amount.]

   c. $3,700. [This answer is incorrect. This amount incorrectly calculates Julie's standard deduction as earned income plus unearned income. $3,600 + $100 = $3,700.]

   d. $3,900. [This answer is correct. Because Julie can be claimed as a dependent on her parent's 2009 return, under the Code, her standard deduction is limited to earned income plus $300. $3,600 + $300 = $3,900.]

5. Mark is single and 74 years old. In 2009, he earned $3,200 from his part-time job. His daughter will claim him as a dependent on her 2009 tax return. What is Mark's standard deduction for 2009? **(Page 95)**

   a. $2,350. [This answer is incorrect. Single dependent taxpayers over the age of 65 with no earned income are eligible to claim the $950 standard deduction plus the $1,400 additional deduction for elderly single taxpayers; however, because Mark earned income during 2009, his standard deduction is not computed in this manner.]

   b. $4,600. [This answer is incorrect. This amount incorrectly calculates Mark's standard deduction as earned income plus the additional deduction for elderly single taxpayers. $3,200 + $1,400 = $4,600.]

   c. $4,900. [This answer is correct. According to the Code, as a single taxpayer claimed as a dependent on his daughter's return, Mark can claim a standard deduction equal to earned income plus $300. However, because he is age 65 or older he is also eligible for the additional deduction for elderly taxpayers. $3,200 + $300 + $1,400 = $4,900.]

   d. $5,700. [This answer is incorrect. This amount represents the standard deduction amount for a single taxpayer for tax year 2009. This amount does not take into account Mark being claimed as a dependent on another taxpayer's return or the fact that he is age 65 or older.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TDBTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Select the answer choice that correctly classifies deductions based on whether or not they are subject to any phase-out rules.

1. Subject to Phase-out Rules	2. **Not** Subject to Phase-out Rules
i. Itemized deductions and personal exemptions	iv. The standard deduction
ii. Itemized deductions, personal exemptions, the standard deduction	v. Itemized deductions, personal exemptions, the standard deduction
iii. Itemized deductions	

   a. 1 and i; 2 and iv.

   b. 1 and ii, 2 and v.

   c. 1 and iii; 2 and v.

   d. 1 and iii, 2 and iv.

2. Joel is a tax accountant for a small firm. He is currently computing a client's alternative minimum tax (AMT). His client itemized for regular tax purposes. In Joel's computation of his client's AMT Joel deducted: the standard deduction, $3,000 in charitable contributions, $1,000 in investment interest, and $2,500 in housing interest. Based on the given information, what mistake did Joel make when computing his client's AMT?

   a. He deducted the standard deduction.

   b. He deducted charitable contributions.

   c. He deducted investment interest expense.

   d. He deducted housing interest expense.

3. Marie is 72 years old and lives by herself in Brentwood Retirement Village. What is Marie's standard deduction for her 2009 tax return?

   a. $6,800.

   b. $7,100.

   c. $9,750.

   d. $12,500.

4. Daniel, age 16, earned $3,700 during the summer of 2009. He also has $550 of interest income. His parents will claim him as a dependent on their 2009 tax return. What is Daniel's taxable income?

   a. $0.

   b. $250.

   c. $3,400.

   d. $4,250.

5. Sheryl, single, blind, and 67 years old, is claimed as a dependent by her son Alex. Sheryl earned $200 during 2009. What is Sheryl's standard deduction for 2009?

   a. $2,350.

   b. $3,150.

   c. $3,300.

   d. $3,750.

Lesson 2: Medical Expenses

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.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:
- Identify deductible medical expense.
- Calculate the deduction for medical expenses.

How to Identify Deductible Medical Expenses of a Dependent

General Rules for Dependent's Medical Deduction

A taxpayer's medical expenses include expenses paid for a person who meets the Section 152 definition of a dependent. However, IRC Sec. 213(a) expands the definition to also include a dependent child who filed a joint return with a spouse, a relative who would have qualified except for exceeding the income level, or anyone who would have qualified as the taxpayer's dependent but was claimed as a dependent on another person's return. Medical expenses paid for a dependent claimed under a multiple support agreement are also deductible.

In addition, either divorced (or separated) parent can deduct medical expenses paid for a child, regardless of which parent claims the personal exemption or whether the custodial parent releases the claim to the exemption, if the two parents together provide more than half of the child's support.

Example 2A-1 Child's medical expenses qualifying for taxpayer's deduction.

Leon, age 22, receives more than 50% of his support from his parents. Leon earned $3,700 in 2009 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, or (2) a "qualifying relative" because his gross income is higher than the $3,650 exemption amount for 2009. However, his parents can still deduct (subject to the 7.5%-of-AGI limitation) the medical expenses they paid for Leon in 2009 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 Leon is a "dependent" for the medical expense deduction, but not for the personal exemption.

Example 2A-2 Married dependent child.

Marcie, age 20, is married and a full-time student but receives more than half of her support from her parents, who also paid $1,200 of her medical bills in 2009. Marcie filed a joint 2009 tax return with her husband, Max. Even though Marcie cannot be claimed as a dependent on her parents' return because she filed jointly with

Max, her parents can deduct (subject to the 7.5%-of-AGI limitation) the medical expenses because she meets the Section 213(a) definition of a dependent. For purposes of the medical deduction, the marital status of an otherwise qualifying child is ignored.

Example 2A-3 Dependent parent qualifying for medical expense deduction.

Georgia, age 70, receives more than 50% of her support from her daughter, Janet, who also paid $2,000 of Georgia's medical expenses in 2009. Georgia earned $3,500 in 2009 from a part-time job; therefore, she cannot be claimed as a dependent on Janet's return. However, Janet still can deduct (subject to the 7.5%-of-AGI limitation) the $2,000 of medical expenses because Georgia meets the definition of a dependent for the medical expense deduction, even though Janet 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.

Private School Tuition for Special School

Often, parents incur the costs of specialized schooling for their dependent children because of a medical condition. Education is not normally viewed as medical care. However, when a physician recommends special education to correct a medical condition, the education constitutes deductible medical care. Utilizing the resources of the institution to alleviate the medical condition must be the principal reason for the child's attendance. Any meals, lodging, or ordinary education received must be incidental to the special education provided. The IRS has privately ruled that when a physician diagnosed children with severe dyslexia that handicapped their ability to learn, requiring special education to correct that problem would constitute medical care. Thus, the tuition paid by the taxpayer for the children to attend a private school, which provided a program of specialized education to enable the children to deal with the learning handicap of dyslexia so they can later move on to study at a regular school, is deductible under IRC Sec. 213.

How to Claim Medical Deductions for Capital Expenditures

Residential Expenditures

Taxpayers can deduct the cost of capital expenditures on the home to accommodate an individual's medical needs. However, the deduction for medically required capital expenditures for permanent improvements to the home that would not ordinarily be for medical care only qualify to the extent the costs exceed the increase in the home's value, if the expenditure is directly related to medical care.

If a capital expenditure for the home qualifies as a medical expense, its operating costs and upkeep also qualify as medical expenses as long as the medical requirement continues.

Example 2B-1 Medical capital expenditures for taxpayer's home.

As prescribed by their physician for their son's allergies, John and Sally installed a central air conditioner with a special filtration system in their home. The system, including installation, cost $6,200. However, the system increased the home's value by $1,000. What, if anything, can be claimed as a medical expense?

The difference between the cost of the air conditioner and the increase in the home's value is a medical expense ($5,200). In addition, the system maintenance costs are medical expenses as long as their son is a dependent and his medical condition persists.

Capital expenditures to adapt a residence to accommodate a handicapped taxpayer, his spouse, or his dependent who lives with him generally will not increase the value of the residence. When this is the case, such expenditures are fully deductible as medical expenses in the year paid. Examples include constructing entrance or exit ramps, modifying stairs, automated chair lifts to manage stairs, and widening doorways.

Additional costs incurred for personal or aesthetic reasons while making alterations to accommodate a handicapped condition do not qualify as medical expenses. For example, if the taxpayer installs ornate wrought-iron handrails and decorative wainscoting, only the cost of installing handrails adequate to accommodate the handicapped condition is allowed as a medical expense.

Medically necessary improvements incurred in the construction of a new home are properly deducted in the year the home becomes habitable, not as payments are made in the process. In *Zipkin*, the district court agreed with the taxpayer's position that (1) the home provided no medical benefit until it proved habitable, and (2) the amount of the deduction could not be ascertained until after the home was complete, since the deduction was the difference between the actual cost of construction and the home's fair market value.

Personal Property Expenditures

Taxpayers can treat capital expenditures, other than on the home, as medical expenses if they directly relate to the sick or handicapped person and are expended for a medical reason. Examples of these kinds of capital expenditures include (1) an autoette (small three-wheeled vehicle for a disabled person), (2) telephone equipment for the hearing impaired, (3) a removable air conditioner in the sick person's room, (4) a guide dog for a blind person, (5) special hand controls for a car or van, (6) improvements to property rented by a handicapped person when the landlord makes no reimbursement or rent reduction, (7) television equipment to display the audio portion of a program as subtitles for the deaf or hearing impaired, and (8) home exercise equipment specifically prescribed to treat obesity. However, the deductible amount must be reduced by any amounts paid for by insurance (e.g., Medicare).

Example 2B-2 Deductible cost of specially designed van.

Helen, who is confined to a wheelchair, purchased a specially designed van for $45,000 that allows her to drive. The special equipment includes ramps for getting in and out, floor locks to hold a wheelchair in place, and a raised roof to provide sufficient headroom for a person in a wheelchair. Comparable vans without the special equipment sell for $35,000.

Helen can deduct as a medical expense only the cost attributable to the special design of the van. This cost is defined as the difference between the specially equipped van and a comparable van of standard design, or $10,000 in this case.

If medical equipment or other property for which a medical expense deduction was claimed is sold, a taxable gain could result (subject to the tax benefit rule) because the property's basis is reduced by any deduction previously allowed.

How to Claim Deductions for Long-term Care Expenses and Payments to Long-term Care Institutions

General Guidelines for Long-term Care Expenses

Medical expenses deductible on Schedule A include amounts paid for qualified long-term care services. Such services are defined as necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services (as well as maintenance or personal care services) that are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health care practitioner. A licensed health care practitioner is a physician, registered professional nurse, licensed social worker, or other individual who meets requirements specified by the IRS.

A chronically ill individual is one who has been certified by a licensed health care practitioner within the last 12 months as:

1. being unable to perform at least two activities of daily living (eating, toileting, transferring, bathing, dressing, and continence) without substantial assistance for at least 90 days due to a loss of functional capacity;

2. having a similar level of disability (as determined under regulations to be prescribed by the IRS); or

3. requiring substantial supervision to protect against safety or health threats caused by the individual's severe cognitive impairment.

Notice 97-31provides guidance on the first and last of these three definitions of when a taxpayer is chronically ill. It refers to these as the Activities of Daily Living (ADL) trigger and the cognitive impairment trigger, respectively.

Activities of Daily Living (ADL) Trigger. The ADL trigger hinges on substantial assistance from another individual. Notice 97-31 defines *substantial assistance* as:

1. hands-on assistance, meaning the physical assistance of another person is required for the individual to perform ADLs, or

2. standby assistance, meaning another person's presence within arm's reach of the individual is necessary to prevent injury while the individual is performing ADLs (for example, being ready to catch the individual in the event of a fall during bathing or dressing, or to prevent choking while eating).

The notice also clarifies that the 90-day requirement does not establish a waiting period before which expenses are deductible long-term care expenses. Rather, a licensed health care practitioner must certify that the individual is expected to be unable to perform two or more ADLs for at least 90 days due to a loss of functional capacity.

Cognitive Impairment Trigger. Notice 97-31 also defines two key terms of the cognitive impairment trigger—the *substantial supervision* required to protect the individual's health and safety, and the *severe cognitive impairment* causing the need for supervision. Substantial supervision means continual supervision that is necessary to protect the individual from threats to his or her safety, such as may result from wandering. Such supervision can include cuing by verbal prompting, gestures, or other demonstrations.

Severe cognitive impairment means a loss or deterioration in intellectual capacity that is comparable to Alzheimer's disease and similar forms of irreversible dementia, which is measured by clinical evidence and standardized tests that reliably measure impairment in the individual's (1) short- or long-term memory; (2) orientation to people, places, or time; and (3) deductive or abstract reasoning.

Costs of Nursing Homes, Assisted Living, and Other Long-term Care Facilities

Previously, amounts paid to nursing homes and other institutions qualified as medical expenses only if medical care was a principal reason for the placement or, if medical care was not a principal reason, only to the extent the cost was attributed to medical care provided by the institution. The requirement that medical care be received as a prerequisite to medical expense treatment generally allowed only residents of nursing homes (where skilled medical or nursing care was provided) the opportunity to deduct all or part of their costs.

With the enactment of IRC Sec. 213(d)(1), the focus is now on long-term care rather than medical care. Thus, the deductibility of amounts paid to institutions now hinges on the particular needs and impairments of the individual and the services provided by the institution, not on whether the individual receives and the institution is qualified to provide medical care. This enables amounts paid to nursing homes as well as other long-term care institutions (primarily assisted living facilities) to qualify as medical expenses.

Example 2C-1 Deducting nursing home costs.

Mildred, age 84, suffered a stroke and now requires ongoing medical attention. She also needs help eating, bathing, and toileting. On the recommendation of her doctor, she enters a nursing home that provides the medical and other care she needs. She pays the nursing home $35,000 in 2009.

The entire $35,000 paid to the nursing home is deductible on Mildred's 2009 Form 1040 as a medical expense (subject to the 7.5%-of-AGI limitation) because it is for qualified long-term care services. Mildred qualifies as a chronically ill individual because she is unable to perform at least two ADLs.

Example 2C-2 Deducting amounts paid to an assisted living facility.

Assume the same facts as in Example 2C-1, except Mildred does not require ongoing medical attention but still needs assistance eating, bathing, and toileting. Because she does not require medical care, her doctor recommends she enter an assisted living facility (ALF) rather than a nursing home. The ALF provides her the custodial care she requires. She pays the ALF $25,000 in 2009.

The entire $25,000 qualifies as a medical expense and is deductible on Mildred's 2009 Form 1040 (subject to the 7.5%-of-AGI limitation). Medical care is not a requirement if Mildred qualifies as a chronically ill individual and incurs the cost pursuant to a plan prescribed by her doctor (or other licensed health care practitioner).

Making the Deduction for In-home Health Care Costs

Many elderly or handicapped individuals employ private-duty nurses or attendants as an alternative to moving to a nursing home or other long-term care facility. The cost of these in-home services is deductible as a medical expense if they qualify as either (1) medical care or (2) long-term care services. To qualify as long-term care services, the taxpayer must be chronically ill and the services must be pursuant to a plan prescribed by a licensed health care practitioner.

If the services provided are of a kind generally performed by a nurse, wages and other amounts paid for the services are deductible medical expenses even if the person providing the services is not a licensed nurse. However, long-term care services provided by a relative or spouse are not deductible as medical expenses unless the relative is a licensed professional for those services.

Example 2D-1 Expenses incurred for in-home care.

Myrtle is 88 years old and wants to continue to live in her home, although she requires assistance with medication, dressing, bathing, and grooming. Myrtle hires a sitter to live in her home, administer the medication, and otherwise care for her condition. She provides a salary and meals and pays social security taxes for the sitter. Since the services provided are the same as those provided by a nurse, the salary, meals, payroll taxes, and additional expenses incurred are deductible as medical expenses. If the sitter also provides personal and household services (such as cooking and cleaning), the costs must be allocated between medical and other services on the basis of time spent to determine the deductible portion of the expense. However, if the primary purpose of the maintenance or personal care services is providing a chronically ill individual with needed assistance with his or her disabilities, they are qualified long-term care services and the expenses are deductible.

Variation: Assume the same facts except Myrtle does not require assistance with medication or specific medical care. If a licensed health care practitioner certifies that Myrtle needs assistance with at least two ADLs (e.g., bathing and dressing), she is treated as a chronically ill individual. Thus, if the in-home services Myrtle receives are provided pursuant to a plan of care prescribed by a licensed health care practitioner, the costs are qualified long-term care expenses and can be deducted as medical expenses (subject to allocation if household services are also provided). This is the case even if the individual providing the services (except for a relative) is not a licensed nurse.

How to Claim Deductions for Retirement Community Fees (Lifetime Care)

Deducting Fees as Medical Expenses

Some retirement communities require a substantial one-time entrance or founder's fee in exchange for the facility's promise to provide lifetime living accommodations and care that includes medical care (i.e., lifetime care). In addition, the retirement community may charge a monthly fee. In Ltr. Ruls. 8930023 and 8930024, the IRS stated that it has no published position regarding the method of allocating fees between amounts properly deductible and not deductible as medical expenses. However, Rev. Rul. 76-481 states that to the extent the retirement community can document a reasonable estimate of the percentage of its overall operating expenses spent for providing medical care, that percentage can be applied to the one-time and continuing payments to the facility. Practitioners should note however, in *Finzer* a federal District Court denied an amended return based on a refund claim for the deduction of a portion of a one-time entrance fee as a medical expense based on the fact that 90% (minimum) of the fee was refundable to the taxpayers or their estate. Finally, the Tax Court supported using a percentage to determine the amount of monthly service fees allocable to medical care when the IRS attempted to force the taxpayer to use an actuarial method yielding a lesser amount.

The amount of operating expenses allocated to the facility's cost of providing medical care to the taxpayer, spouse, or dependent qualifies as a medical expense in the year paid, even though medical services will be provided in future years. However, current deductions of payments for future medical care (extending substantially beyond the close of the tax year) generally are not allowed unless the future care is purchased in connection with obtaining lifetime care of the type described in this lesson.

Example 2E-1 Medical expense portion of payments to retirement care facility.

Bertha, age 69, made arrangements to enter the Oaks Retirement Community. For Oaks' promise to provide her with living accommodations, meals, activities, and lifetime care, including medical care, she paid an entrance fee of $90,000 and will pay a monthly fee of $1,500. Oaks provided Bertha with documentation that supports an estimate that 35% of its expenses are related to the provision of medical care to the residents.

Based on this information, Bertha should be entitled to claim 35% of the $90,000 entrance fee (or $31,500) as well as 35% of the monthly fees as medical expenses in the year paid.

If an individual is chronically ill and under a prescribed care plan when the entrance fee is paid, a greater percentage of the fee may be deductible since qualified long-term care encompasses a broader range of services than medical care.

Avoiding Imputed Interest Income on Entrance Fees

Unless certain requirements are met, a refundable initial payment to a continuing care facility is treated as a below-market loan subject to the imputed interest rules. If those rules apply, interest is deemed to have been paid by the facility to the resident, who would have to include the imputed interest in gross income. Thus, a resident of a continuing care facility could be subject to tax on income that was never received.

The below-market loan rules do not apply to a refundable deposit to a qualified continuing care facility under a continuing care contract if:

1. the taxpayer (or spouse) is age 62 or older before the end of the year, and

2. the facility has both an independent living unit plus an assisted living and/or nursing facility.

The imputed interest rules apply only to entrance fees that are refundable. The rules do not apply if the fees are advance payments. For example, fees that are refundable on a declining prorata basis over a specified period are treated as advance fee payments, rather than loans. Furthermore, the IRS has ruled that the imputed interest provisions do not apply unless the deposit is paid to a qualified continuing care facility under IRC Sec. 7872(g)(4) until regulations are issued that provide otherwise.

Example 2E-2 Avoiding below-market loans to continuing care facilities.

In 2009, Maude, a 75-year-old widow, made a $100,000 entrance payment to a continuing care facility that offers lifetime living quarters, board, a specified level of health care, and other personal care. The $100,000 is refundable upon Maude's death or if she moves away from the facility and the space is resold. Although she does not currently need long-term or nursing care, the contract stipulates that such care will be provided if Maude's health requires it. No additional payment will be necessary if Maude requires increased personal care services or long-term and skilled nursing care.

Since Maude had reached age 62 before December 31, 2008, interest is not imputed.

Medical Care Insurance and Long-term Care Insurance Deductions

Medical Care Insurance

Deductible medical expenses include premiums paid for insurance covering medical care expenses (as defined in the Introduction to this lesson) for the taxpayer, his or her spouse, and his dependents. If a policy provides coverage in addition to medical care (e.g., loss of limb, life, or sight), the medical care portion of the premium is deductible only if it is separately stated and reasonable in relation to the total premium.

Medicare. Medicare Part A (basic Medicare) premiums paid by taxpayers covered by social security (i.e., Medicare portion of self-employment tax for self-employed individuals and employee half of Medicare tax for employees) are

not deductible. Medicare Part A premiums voluntarily paid by a taxpayer age 65 or older not otherwise entitled to social security benefits are deductible.

Medicare Part B premiums paid by taxpayers age 65 and older are deductible (presumably, this includes the means-tested premiums charged to higher income individuals). Premiums for Medicare D (prescription drug coverage) are also deductible.

Prepaid Medical Insurance. Generally, no deduction is allowed for prepaid medical insurance. However, premiums paid by a taxpayer under age 65 for medical insurance (other than long-term care insurance) that covers the taxpayer, spouse, or dependent after the taxpayer turns age 65 are deductible when paid if they are paid in equal installments for at least 10 years or until he reaches age 65 (but not for less than five years).

Long-term Care Insurance

For 2009, qualified long-term care (LTC) insurance premiums are deductible as medical expenses (subject to the 7.5%-of-AGI floor) within the following limits (depending on the taxpayer's age at the end of the tax year).

Age on December 31, 2009	Maximum Deduction
Age 40 or under	$ 320
Age 41 to 50	600
Age 51 to 60	1,190
Age 61 to 70	3,180
Over age 70	3,980

Example 2F-1 Deducting long-term care premiums.

Steve, age 56 and an employee, paid $3,000 for medical insurance coverage and $1,500 for qualifying LTC insurance premiums in 2009. Steve's health insurance deduction for 2009 is calculated as follows:

Medical care insurance premiums	$ 3,000
LTC insurance premiums (limited to $1,190 maximum based on Steve's age)	1,190
Total deductible premiums	$ 4,190

The $4,190 is deductible in 2009 as an itemized medical expense to the extent it and other unreimbursed medical expenses exceed 7.5% of AGI. The $310 ($1,500 − $1,190 maximum) excess LTC insurance premiums paid are not deductible.

Example 2F-2 Deducting a married couple's medical and long-term care insurance.

Howard and Marion file a joint return. They are both over age 70 and retired. Their SSA-1099 Social Security Benefit Statements show that each paid $525 for Medicare Part B coverage. Howard also had $960 deducted from his company pension for Medigap insurance his employer carries for the company's retirees. Howard and Marion pay $2,400 each for qualified LTC insurance. Their medical and LTC insurance premiums for the year total $6,810 ($525 + $525 + $960 + $2,400 + $2,400), which they can deduct on Schedule A (subject to the 7.5% AGI limit).

Variation: Assume the same facts, except Howard has significant health issues, so his LTC insurance costs $4,000 rather than $2,400. Marion still pays $2,400. Their deductible medical and LTC insurance premiums for the year total $8,390 [$525 + $525 + $960 + $3,980 (maximum allowed) + $2,400], which they can deduct on Schedule A (subject to the 7.5% AGI limit).

What Qualifies as an LTC Insurance Policy? To qualify for the deduction, the underlying policy must provide coverage only for qualified long-term care services, be guaranteed renewable, have no cash value, and use refunds or dividends only to reduce future benefits. A qualifying policy does not cover expenses eligible for Medicare reimbursement unless Medicare is a secondary payer or the policy pays a per diem benefit without regard to actual

expenses. In addition, certain consumer protection standards must be met. (IRC Sec. 7702B describes qualifying policies and services, and Reg. 1.7702B-1 describes consumer protection requirements.)

Qualifying long-term care expenses include necessary diagnostic and preventive care as well as therapy, rehabilitation, and treatment. They also include maintenance and personal care services for chronically ill individuals if the services are prescribed by a licensed health care practitioner.

SELF-STUDY QUIZ

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

6. Select the scenario that would allow a parent to claim his or her child as a dependent for both the medical expense deduction and personal exemption.

   a. Matt, age 21, is a part-time student at Williamson College. During 2009, he earned $4,200 waiting tables. His parents provide more than 50% of his support.

   b. Alice, age 19, is a part-time student and earned $3,600 during the summer. Her parents provide 25% of her support.

   c. Henry, age 20, is a married, full-time student at Clarks University. He receives 65% of his support from his parents. He will file a joint return with his wife for their 2008 tax return.

   d. Barbara, age 22, is a full-time student at Alabama State University. She earned $2,200 during 2009 from her part-time job. Her parents provide more than half of her support.

7. Marie had the following expenses during 2009:

(1)	Purchased specialty vehicle that accommodates her wheelchair	$36,000
(2)	Installed entrance ramps to her home	700

   Additional Information: Comparable vehicles without the special equipment sell for $22,000. Marie's Medicare paid $200 of the cost to install entrance ramps to her home.

   What amount can be claimed as a medical expense?

   a. $14,500.

   b. $14,700.

   c. $22,700.

   d. $36,500.

8. Joel, age 75, only requires physical assistance from another person when bathing and eating. This is an example of which of the following?

   a. Standby assistance.

   b. Hands-on assistance.

   c. Substantial supervision.

   d. Severe cognitive impairment.

9. Harold is 82 years old and still lives in his home. This year, however, Harold is no longer able to perform his usual activities and is considered chronically ill. He has hired a nurse to assist in him in bathing, dressing, administering medication, and monitoring his breathing apparatus. During the nurse's shift, she also cooks, cleans, and buys the groceries. Based on the given information, wages paid for which of the following nurse's services would qualify as a medical expense?

    a. Bathing.

    b. Cooking.

    c. Cleaning.

    d. Buying groceries.

10. Marvin, age 50, paid $2,600 for medical insurance coverage in 2009 and $890 for qualifying long-term care insurance premiums for the year. Marvin's health insurance deduction for 2009 is:

    a. $890.

    b. $2,600.

    c. $3,200.

    d. $3,490.

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.)**

6. Select the scenario that would allow a parent to claim his or her child as a dependent for both the medical expense deduction and personal exemption. **(Page 103)**

   a. Matt, age 21, is a part-time student at Williamson College. During 2009, he earned $4,200 waiting tables. His parents provide more than 50% of his support. [This answer is incorrect. While Matt's parents would be eligible to claim him as a dependent for the medical expense deduction, they would be unable to claim him as a dependent for the personal exemption because he is over the age of 18, is only a part-time student, and he earned more than the personal exemption amount of $3,650.]

   b. Alice, age 19, is a part-time student and earned $3,700 during the summer. Her parents provide 25% of her support. [This answer is incorrect. Alice's parents would be unable to claim her as a dependent for the personal exemption because she is not considered a qualifying child or qualifying relative. Also her parents would not be eligible for the medical expense deduction because they only provided a fourth of her support.]

   c. Henry, age 20 is a married, full-time student at Clarks University. He receives 65% of his support from his parents. He will file a joint return with his wife for their 2009 tax return. [This answer is incorrect. Henry's parents would be allowed to claim him as a dependent for the medical expense deduction because they provided more than 50% of his support; however, because he is filing a joint return they would be unable to claim him as a dependent for the personal exemption.]

   d. Barbara, age 22, is a full-time student at Alabama State University. She earned $2,200 during 2009 from her part-time job. Her parents provide more than half of her support. [This answer is correct. Under the Internal Revenue Code, though Barbara is not considered a qualifying child, she is considered a qualifying relative for purposes of the personal exemption because she made less than the personal exemption amount. Also, because her parent's provided more than 50% of her support, she may be claimed as a dependent for the medical expense deduction.]

7. Marie had the following expenses during 2009:

(1)	Purchased specialty vehicle that accommodates her wheelchair	$36,000
(2)	Installed entrance ramps to her home	700

   Additional Information: Comparable vehicles without the special equipment sell for $22,000. Marie's Medicare paid $200 of the cost to install entrance ramps to her home.

   What amount can be claimed as a medical expense? **(Page 104)**

   a. $14,500. [This answer is correct. Both of Marie's expenses represent a medical expense; however, under the IRS Revenue Rules, she is only allowed to deduct the cost associated with her vehicle's special design. $36,000 − $22,000 = $14,000. According to the IRS regulations, the amount paid by her Medicare must be deducted from the cost of installing the ramps $700 − $200 = $500. Marie's total medical expenses is therefore $14,000 + $500 = $14,500.]

   b. $14,700. [This answer is incorrect. While this answer takes into account the difference in the cost of a standard vehicle and her specialty vehicle, it does not properly reflect the deduction for amounts paid to make improvements to her property.]

   c. $22,700. [This answer is incorrect. Based on the rules and regulations provided by the IRS, $22,000 is part of the calculation for Marie's deduction on the van, but further procedures must be applied to determine the amount Marie can deduct. Additional calculations on the $700 are also required to determine the amount Marie can deduct for the ramps.]

d. $36,500. [This answer is incorrect. While this amount takes into account how the Medicare reimbursement affects the amount Marie can deduct for the ramps, it does not properly reflect the amount Marie can deduct for the van according to the applicable Revenue Ruling.]

8. Joel, age 75, only requires physical assistance from another person when bathing and eating. This is an example of which of the following? **(Page 105)**

   a. Standby assistance. [This answer is incorrect. Standby assistance refers to instances when another person's presence within arm's reach of the individual is necessary to prevent injury while the individual is performing activities of daily living.]

   b. Hands-on assistance. [This answer is correct. According to IRS Notice 97-31, hands-on assistance refers to instances when the physical assistance of another person is required for the individual to perform activities of daily living.]

   c. Substantial supervision. [This answer is incorrect. Substantial supervision refers to instances when continual supervision is necessary to protect the individual from threats to his or her safety caused by the individual's severe cognitive impairment.]

   d. Severe cognitive impairment. [This answer is incorrect. With the information given, Joel does not require substantial supervision, as he does not suffer a loss or deterioration in intellectual capacity.]

9. Harold is 82 years old and still lives in his home. This year, however, Harold is no longer able to perform his usual activities and is considered chronically ill. He has hired a nurse to assist in him in bathing, dressing, administering medication, and monitor his breathing apparatus. During the nurse's shift she also cooks, cleans, and buys the groceries. Based on the given information, wages paid for which of the following nurse's services would qualify as a medical expense? **(Page 107)**

   a. Bathing. [This answer is correct. The cost of in-home services related to medical care or long-term care are deductible as a medical expense under the Internal Revenue Code.]

   b. Cooking. [This answer is incorrect. Cooking is a personal service and should not be included when computing a taxpayer's medical expense.]

   c. Cleaning. [This answer is incorrect. Household services such as cleaning and doing laundry are not considered medical expenses.]

   d. Buying groceries. [This answer is incorrect. Personal services such as buying groceries and running personal errands are not deductible as medical expenses.]

10. Marvin, age 50, paid $2,600 for medical insurance coverage in 2009 and $890 for qualifying long-term care insurance premiums for the year. Marvin's health insurance deduction for 2009 is: **(Page 108)**

    a. $890. [This answer is incorrect. This amount does not correctly address the amount Marvin could deduct for his medical insurance coverage under the Internal Revenue Code. It also does not factor Marvin's age into account when calculating the deduction for his long-term care insurance.]

    b. $2,600. [This answer is incorrect. This amount does not correctly address the amount Marvin could deduct for his long-term care insurance under the Code.]

    c. $3,200. [This answer is correct. Under the Code, Marvin is allowed to deduct the full amount he paid for medical insurance coverage and limited to $600 of the amount he paid for qualifying long-term care insurance premiums. $2,600 + $600 = $3,200.]

    d. $3,490. [This answer is incorrect. This amount assumes that Marvin can deduct the full amount for both the medical insurance and the long-term care insurance. It does not factor his age into account. If his deduction is calculated using the rules in the Code, Marvin's deduction will be less than this amount.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TDBTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

6. In which of the following cases would the expenditure be fully deductible in the year paid as a medical expense?

   a. Joan's physician prescribed her to install a special heating and cooling system that would minimize the effects of her asthma. The system including installation, cost $4,800. The system in turn increased her home's value by $1,500.

   b. After watching a special on TV, Georgia has decided that her son must have ADHD. She has not had her diagnosis confirmed by her son's pediatrician, but has decided to send her son to a school with specialized services for students with learning disabilities. Cost of attendance is $5,000 annually.

   c. After an accident, Paul is now confined to a wheelchair. As a result, he has installed, at a cost of $500, a wheelchair ramp to enter and exit his home.

   d. Judy was told by her doctor that she will need to install handrails in her home to alleviate the pressure sustained by her legs. She spent $1,000 purchasing antique handrails, even though she could have easily purchased handrails for $200.

7. Joe had the following expenses during 2009:

1. Purchased water filtration system prescribed by his doctor	$	5,400
2. Installed special hand controls on vehicle	$	800
3. Widened doorways for wheelchair access	$	1,200

   Additional Information: The water filtration system increased his home's value by $500. Joe's insurance paid $50 of the cost to install hand controls on his vehicle.

   What amount can be claimed as a medical expense?

   a. $5,650.

   b. $6,850.

   c. $7,350.

   d. $7,400.

8. In order to be considered chronically ill, what is the minimum number of activities of daily living (ADL) a taxpayer must be unable to perform without substantial assistance for a period of at least 90 days due to a loss of functional capacity?

   a. One.

   b. Two.

   c. Three.

   d. Four.

9. Neil, age 76, entered the Hollow Ridge Retirement Community in January 2009. The community promises lifetime living accommodations and care. He paid an entrance fee of $40,000 and will pay a monthly fee of $850. Hollow Ridge provided Neil with documentation indicating that approximately 40% of its expenses are related to providing medical care to its residents. Based on the facts provided in this scenario, what is Neil's qualifying medical expense for 2009?

   a. $4,080.

   b. $10,200.

   c. $20,080.

   d. $50,200.

10. Jim, age 72, and April, age 67, will file a joint return for 2009. Jim pays $3,500 for qualified long-term care insurance premiums and April pays $3,200. They each paid $400 for Medicare Part B coverage. Their medical and long-term care insurance premium deductions for the year total:

    a. $800.

    b. $6,680.

    c. $7,480.

    d. $7,500.

Lesson 3: 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. 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.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:
- Calculate charitable contribution deductions.
- Identify the rules and requirements for charitable contribution deductions.

The AGI Percentage Limitations

The charitable contribution deduction allowed for any one year is based on the taxpayer's contribution base, which is the taxpayer's adjusted gross income (AGI) without regard to net operating loss carrybacks. Also, the amount of charitable contributions an individual can deduct in any one tax year is limited depending on the types of organizations to which the contributions were made, the kinds of property contributed, and the amount or value of the donated property.

Generally, five different percentage of AGI limitations apply to charitable contributions: two 50% limitations, two 30% limitations and the 20% limitation. However, there is a 100% limitation for qualified conservation contributions by qualified farmers and ranchers.

The 50% Limitations

The first 50% limitation provides that aggregate deductible contributions (including those subject to the separate 20% or 30% limitations) cannot exceed 50% of AGI. Excess contributions are carried over to the succeeding five tax years and are used on a first-in, first-out (FIFO) basis. However, for any tax year, all current-year contributions are deducted first.

The second 50% limitation refers to gifts (other than capital gain property) to certain types of charitable organizations ("50% charities") that are considered first in computing the overall 50% limit. (This ordering process applies when a taxpayer also has contributions to non-50% charities.) The most common 50% charities include churches, schools, hospitals, governmental entities, private operating foundations, and other nonprofit agencies organized for charitable, religious, educational, scientific, or literary purposes. (IRS Pub. 78 categorizes qualified organizations as 50% or non-50% organizations.)

The 30% Limitations

Two different 30% limitations apply to two types of contributions. The first limitation (the "regular" 30% limitation) applies to gifts of property (including cash) other than capital gain property to charities that do not qualify as 50% charities. Common charities in this group include veterans organizations, domestic fraternal societies, nonprofit cemeteries, and certain private foundations. It also applies to gifts *for the use of* any charitable organization (e.g., income interest in trust property or amounts spent for a student living in the home). The second 30% limitation (the "special" 30% limitation) applies to gifts of capital gain property to a 50% charity. (See Example 3A-1.)

Normally, a contribution of capital gain property is measured by its FMV on the date of the gift. However, a taxpayer willing to limit the deduction to the tax basis of the property, can elect to use the 50% limitation rather than the "special" 30% limitation for capital gain property contributed to a 50% charity. The election, once made, is irrevocable. It applies to all gifts that would otherwise fall under the special 30% limitation for that year, including carryovers subject to the special 30% limitation.

Both 30% limitations are computed after considering the 50% limitation on gifts to 50% charities, but before considering the 20% limitation discussed in the following paragraphs. Unused 30% contributions are carried over to the succeeding five tax years and retain their character as "special" or "regular" 30% contributions.

The 20% Limitation

The 20% limitation applies to gifts of capital gain property to non-50% charities (e.g., most family-funded private foundations). This 20% limit is applied after considering the 50% and 30% limits (if any) for the tax year. The deductible amount of 20% contributions is limited to the lesser of (1) 50% of AGI reduced by 50% contributions and regular 30% contributions, (2) 30% of AGI reduced by special 30% contributions, or (3) 20% of AGI. Excess 20% contributions are carried over to the succeeding five tax years and retain their 20% character. (See Example 3B-4.)

Applying the Limitations

Under the overall 50% limitation, the total charitable contribution deduction cannot exceed 50% of AGI. When contributions subject to different AGI limitations are made, the limitations are applied in the following order:

1. *50% Limitation.* Contributions of cash and noncapital gain property (i.e., generally ordinary income property, capital gain property other than long-term gain property, and long-term capital gain property for which an election to use basis has been made) to 50% charities, not to exceed 50% of AGI.

2. *Regular 30% Limitation.* Contributions of noncapital gain property (including cash) to non-50% charities and any contributions (other than capital gain property to 50% charities) "for the use of" any charity, to the extent of the lesser of:

    a. 30% of AGI, or

    b. 50% of AGI reduced by *all* contributions to 50% charities (i.e., reduced by regular 50% contributions plus the *full value* of any capital gain property donated to 50% charities).

3. *Special 30% Limitation.* Contributions of capital gain property to 50% charities, up to the lesser of:

    a. 30% of AGI, or

    b. 50% of AGI less other contributions to 50% charities.

4. *20% Limitation.* Contributions of capital gain property to non-50% charities, to the extent of the lesser of:

    a. 20% of AGI,

    b. 30% of AGI less contributions subject to the 30% limit,

    c. 30% of AGI less contributions of capital gain property to 50% charities, or

    d. 50% of AGI less the total of contributions to 50% limit organizations and contributions subject to the 30% limit.

Example 3A-1 50%, 30%, and 20% limitations in one year.

Valerie's current year AGI is $50,000. During the year, she gave her church (a 50% charity) $2,000 cash and land with a FMV of $30,000 and a basis of $22,000. The land was held for investment for more than 12 months

(i.e., capital gain property). The donation of the land is subject to the special 30% limitation. She also gave $5,000 of capital gain property to a private foundation that is a non-50% charity. The $5,000 contribution is subject to the 20% limitation.

Under the overall 50% limitation, Valerie's total charitable contribution deduction cannot exceed $25,000 (50% of $50,000). The cash contribution is considered first since it was made to a 50% charity. Other charitable contributions are considered in the order previously described, up to 50% of AGI in the aggregate.

Valerie's donation of land is subject to the special 30% of AGI limit. It is included at FMV ($30,000) in applying the 30% limitation. Therefore, Valerie can deduct a maximum of $15,000 ($50,000 AGI × 30%) for the land donation. The unused special 30% contribution ($15,000) is carried over to later years. The $5,000 contribution to the private foundation is subject to the 20% limitation, but is nondeductible because the limitation is reduced to zero because of the full use of the special 30% limitation [(30% × $50,000 AGI) − $30,000 contribution of land = 0] and it carries over for up to five years.

Valerie's current year deduction is limited to $17,000 ($2,000 + $15,000). The aggregate 50% limitation was not reached. Both carryovers will continue to be subject to the special 30% and 20% limit, respectively.

Example 3A-2 Electing to reduce the value of appreciated property to basis to avoid limitation.

Assume the same facts as in Example 3A-1 except the FMV of the land is $23,000. Valerie elects to reduce the deduction for the land (which is "special" 30% capital gain property) to its tax basis rather than FMV. By making this election, the land is treated as noncapital gain property and is thus subject to the 50% limitation (i.e., the special 30% limitation no longer applies).

Valerie's deduction for the land is its basis of $22,000, which is added to the $2,000 cash contribution in applying the 50% limitation. Valerie may now deduct $1,000 of the $5,000 donated to the private foundation because the 20% limitation has not been exceeded and the amount contributed to 50% charities ($24,000) is less than 50% of AGI ($25,000).

Valerie's total deduction for the current year is $25,000: $2,000 cash, $22,000 for land, and $1,000 of capital gain property. The excess 20% contribution ($4,000) to the private foundation is carried over and will be subject to the 20% limitation in future years.

Contribution Carryovers

The total contribution deduction (including carryovers) in a year cannot exceed 50% of AGI. Carryover contributions are subject to the same limits that applied (50%, 30%, special 30%, or 20%) in the year from which they are carried.

For any tax year, all current-year contributions are deducted first. Then, carryover contributions are deducted on a FIFO basis. However, contributions can only be carried to the succeeding five tax years (15 years for qualified conservation easement contributions); they expire if not used. Thus, it is important that the practitioner communicate with the taxpayer about carryover planning strategies.

Example 3B-1 Carryover of 50% contributions.

Turk's 2009 AGI is $20,000. During 2009, he contributed $11,000 cash to his church. He can deduct $10,000 in 2009 (50% of $20,000) and carry over $1,000. In 2010, if he has AGI of $20,000 and contributes $9,000 or less in that year, he can deduct the entire $1,000 carryover. However, if he contributes $9,500 during 2010, he can deduct only $500 of his 2009 carryover. The $500 balance of the carryover is carried over to 2011 and retains its 50% character.

Taxpayers can deduct 30% contribution carryovers to the extent there is room left under the *overall* 50% limit after considering all current-year contributions and 50% carryover contributions.

Example 3B-2 Carryover of 50% and 30% contributions.

In 2009, Roger had AGI of $75,000 and made 50% contributions of $9,000 and 30% contributions of $11,000. In addition, he had a 50% contribution carryover of $12,000, a regular 30% contribution carryover of $5,000, and a special 30% carryover of $6,000 for a total amount available in 2009 of $43,000.

Roger's 2009 deduction is limited to $37,500 (50% of $75,000) computed as follows:

	Total Amount	Deductible in 2009	Carryover to 2010
2009 50% contribution	$ 9,000	$ 9,000	$ —
2009 30% contribution (all current-year contributions considered before any carryovers)	11,000	11,000	—
50% carryover	12,000	12,000	—
Regular 30% carryover (limited because the $6,000 special 30% carryover must be included as a 50% carryover in calculating the 30% limit, as discussed previously)	5,000	—	5,000
Special 30% carryover (limited by the overall 50% limitation)	6,000	5,500	500
Total amount from 2009 contributions	$ 43,000		
Total deductible in 2009		$ 37,500	
Total carried over to 2010			$ 5,500

If the taxpayer does not itemize in a year to which contributions are carried, the carryovers must still be reduced by the amount that would have been deductible (without considering the standard deduction) in the carryover year if deductions had been itemized.

Example 3B-3 Use of carryover in standard deduction year.

Hal has a $500 (50%) contribution carryover to 2009 and makes no 2009 contributions. His 2009 AGI is $40,000, and he uses the $5,700 standard deduction (for 2009) for single taxpayers.

Because Hal's 2009 AGI would permit him to deduct his $500 carryover (i.e., no percentage limitations apply), it is deemed used (i.e., it cannot be carried over to 2010 and subsequent years) even though he receives no tax benefit in 2009.

Example 3B-4 Multiple current-year contributions and carryovers.

Jerry has 2009 AGI of $100,000. His current-year contributions and carryovers from prior years are:

Applicable Limitation	2009 Contributions	Carryovers to 2009	Totals
50% AGI	$ 10,000	$ 3,000	$ 13,000
30% AGI	6,000	2,000	8,000
Special 30% AGI	4,000	1,000	5,000
20% AGI	9,000	16,000	25,000
Totals	$ 29,000	$ 22,000	$ 51,000

Jerry's overall 50% limitation for 2009 is $50,000. He can deduct the amounts shown in the following order:

Category	Amount	Comment
2009 50% contribution	$ 10,000	All 2009 contributions considered first.
2009 30% contribution	6,000	
2009 special 30% contribution	4,000	
2009 20% contribution	9,000	
50% carryover	3,000	50% carryovers used first.
30% carryover	2,000	Entire amount allowed under overall 50% limitation and 30% limitation.
Special 30% carryover	1,000	Entire amount allowed under overall 50% limitation and special 30% limitation.
20% carryover	11,000	Limited by 20% limitation on *combined* current-year and carryover 20% contributions, i.e., [($100,000 × 20%) − $9,000].
Total deductible in 2009	$ 46,000	

The 20% limitation applied even though the overall 50% limitation had not been reached. Jerry has a 20% contribution carryover to 2010 of $5,000 ($16,000 carried into 2009 less $11,000 used).

Substantiating Contributions

The recordkeeping and filing requirements for charitable contribution deductions vary based on whether the contribution is made in cash or property and the amount of cash or the value of the property contributed.

IRS Publication 1771, "Charitable Contributions—Substantiation and Disclosure Requirements," contains the rules for documenting charitable deductions on federal tax returns and also includes additional information regarding acknowledgments provided to donors. A copy of the publication is available on the IRS website at **www.irs.gov**.

A donor will not be allowed any deduction for a contribution of cash, by check, or any other monetary gift regardless of the amount unless the donor retains either (1) a bank record that supports the donation or (2) a written receipt or communication from the charity showing the name of the donee organization, date, and amount of the contribution. A *monetary gift* includes the transfer of a gift card redeemable for cash and a payment made by credit card, electronic fund transfer, an online payment service, or payroll deduction. A *bank record* includes a statement from a financial institution, an electronic fund transfer receipt, a cancelled check, a scanned image of both sides of a cancelled check obtained from a bank website, or a credit card statement. A *written communication* includes electronic mail correspondence.

For contributions made through payroll deductions, the same requirements discussed under "Contributions Made by Payroll Deduction" later in this lesson will satisfy these requirements. There is also a rule that requires donors to obtain certain other additional charity-provided substantiation for cash contributions of $250 or more (explained later in this lesson). Charitable cash handouts—such as cash placed on church collection plates—will not result in any deductions unless the donor obtains a qualifying receipt or written communication.

Property Contributions of Less Than $250

Property donations valued at less than $250 must be substantiated by (1) a written receipt or letter from the charitable organization showing the organization's name, the date and place of the contribution, and a detailed description of the property; or (2) if it is impractical to obtain a receipt, reliable written records containing the following information:

1. The organization's name, the date and place of the contribution, and a detailed description of the property.

2. The FMV of the property at the time contributed and how FMV was calculated (if by appraisal, a signed copy should be kept).

3. The property's cost or basis (if ordinary income or short-term capital gain property).

4. The terms or conditions attached to the gift.

5. The amount of deduction claimed.

6. For securities, the issuer's name, the type of security, and whether it is regularly traded on a stock exchange or over-the-counter market.

Cash and Property Contributions of $250 or More

Donors must also get a written acknowledgment from the charity if the value of the contribution (in cash or other property) is $250 or more—a canceled check or other reliable records are not sufficient proof. (The taxpayer can obtain one written acknowledgment for multiple gifts of $250 or more to the same charity.) The acknowledgment must be obtained no later than the due date (or extended due date, if applicable) of the tax return for the year the contribution was made. If the return is filed before the due date, the donor must possess the acknowledgment when the return is filed. If the required written acknowledgment is not properly completed and timely obtained, the charitable contribution can be disallowed in its entirety. Donees can provide written acknowledgments on paper or electronically (e.g., by emailing the donor).

If a taxpayer gives cash, the amount should be noted on the acknowledgment. If the gift is property, the acknowledgment must describe the property, but the charity does not have to value it. (That is the responsibility of the donor.) If it is a combination of cash and property that adds up to $250 or more, the cash amount should be noted and the property described. The acknowledgment should show the donor's name, but the social security number or business tax ID number is not required.

The written acknowledgment must also contain a statement of whether or not the donee organization provided any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization. If a donor received anything from the charity in return, the acknowledgment must include a good faith estimate of the value of the goods and services the donor received (for example, the value of a charity dinner dance or athletic event tickets) and a disclosure that only the "net" amount is deductible. If only intangible religious benefits (for example, admission to a religious service) are received, the acknowledgment should so indicate, and no valuation of such benefits is required.

The acknowledgment rule does not apply if the net value of the actual donation is less than $250. Therefore, written acknowledgment is not required if a cash contribution of $300 is made and the donor receives a $60 gift in return.

Multiple Contributions That Add up to $250 or More. Each donation is viewed as a separate contribution, regardless of whether the total contributions made by the taxpayer to a donee organization reaches the $250 substantiation limit. The IRS is authorized to issue rules regarding multiple donations of less than $250 if they are made to avoid the substantiation rules. However, the regulations currently do not contain an anti-abuse provision.

Example 3C-1 Contribution of multiple gifts of less than $250.

During the year, Joan gave $100 per month to State University by check. Each $100 gift is considered a separate donation. Therefore, the gifts can be substantiated by canceled checks or receipts from the charity showing the donee name, date, and amount of each contribution. A written acknowledgment from the charity is not required even though the total amount given for the year is $1,200.

Contributions Made by Payroll Deduction. Special rules apply for contributions made by payroll deduction. These rules allow taxpayers to substantiate their contributions with two documents: (1) a pay stub, Form W-2, or other document furnished by the employer that shows the amount of the contribution withheld from the employee's pay during the year; *and* (2) a pledge card or other document prepared by or at the direction of the charity that includes a statement indicating the organization does not provide goods or services in return for donations made by payroll deduction.

Third-party Fund-raising Campaigns. Some charitable organizations (e.g., United Way) solicit contributions in the form of payroll deductions or lump-sum payments to distribute to other charities. In such cases, the distributing organization is the one receiving the contribution for purposes of complying with the $250 or more substantiation

rules. This rule applies regardless of whether such organization distributes the contribution pursuant to the donor's specific instructions or in accordance with the fundraising campaign's general allocation formula. The rule does not apply, however, if the organization ultimately receiving the donation provides goods or services to the donor as part of a transaction where the donor deducts the entire contribution without reduction for the goods or services received in return.

Out-of-pocket Expenses. Volunteers must keep detailed records of any out-of-pocket expenses incurred. 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. The amount of out-of-pocket expenses need not be shown on the receipt. A receipt from the charity is not required if out-of-pocket expenses are less than $250.

Example 3C-2 Substantiation requirements for out-of-pocket expenses.

During the current year, 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 the year, 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.

Assuming their charity-related out-of-pocket expenses otherwise satisfy the rules for claiming a deduction [i.e., they are properly documented and satisfy the Section 170(j) requirement that there be no significant element of personal pleasure involved in the travel], Jett and his wife still 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 return is due or filed).

Matching Contributions. Employers often sponsor a matching program for charitable contributions made by their employees to certain charities. If an employee's contribution to a charity is matched (in whole or in part), and the employee receives goods or services in return for the donation, they are treated as provided solely in consideration for the employee's portion of the total contribution. Therefore, the employee (not the employer) would receive the written acknowledgment from the donee organization indicating the good faith estimate of the value of the goods or services provided by the donee organization and the employee should reduce the amount of the contribution by the value of the goods or services provided.

Donations Related to Preferred Seating at Collegiate Athletic Events. Payments to colleges and universities for the right to purchase tickets to athletic events are generally 80% deductible as charitable contributions. (See Example 3E-3.) For the acknowledgment rule (and the quid pro quo rules discussed in previously), the FMV of such a right is 20% of the amount paid for it. Thus, when the total payment for the right is at least $312.50, the portion of the payment treated as a charitable contribution will be $250 or more and an appropriate acknowledgment will be required to substantiate it.

Contributions by S Corporations, Partnerships, and LLCs. For partnerships, S corporations, and limited liability companies (LLCs), the requirement for receiving an appropriate acknowledgment applies at the entity level even though the entity's income and deductions pass through to the owners' returns. Thus, such an entity must receive an acknowledgment from the donee charity before claiming the contribution on its return and must maintain the acknowledgment in its files. The entity's owners are not required to obtain any additional substantiation before claiming their share of the charitable contribution on their own returns (even if an owner's share is $250 or more).

Property Contributions of More Than $500

When a taxpayer donates property valued at more than $500, Form 8283 (Noncash Charitable Contributions) must be attached to the return. The taxpayer must also keep written records that include the information listed earlier in this lesson for documenting property contributions valued at less than $250, plus report on Form 8283 how and when the property was acquired, and its basis or cost. If the taxpayer cannot provide the cost basis or acquisition date and has reasonable cause for not doing so, an explanatory statement must be attached to the return.

Property Contributions of More Than $5,000

A donor who contributes property, other than publicly traded securities, valued at more than $5,000 during the tax year (whether or not donated to the same donee) must obtain a qualified written appraisal and attach to his return a completed Section B of Form 8283 (Appraisal Summary) signed by the appraiser and the donee organization. In *Obiakor,* a donation of clothing valued in excess of $5,000 was disallowed because the donor failed to obtain an appraisal and attach Form 8283 to their tax return. For nonpublicly traded securities, a written appraisal is required only when the deduction claimed exceeds $10,000. The $5,000 threshold is applied *per item or per group of similar items* (i.e., items of the same category or type, such as clothing, stamp collections, books, paintings, lithographs, nonpublicly traded stock, land or buildings). For example, a donation of five bags of clothing, each valued at $1,500 would be considered a property donation of more than $5,000.

For noncash donations over $500,000, a copy of the appraisal must be attached to the return in addition to Form 8283. However, this requirement does not apply to contributions of securities for which market quotations are readily available on an established securities market, inventory, intellectual property for which the deduction is limited to the lesser of basis or FMV, or vehicles if the donee sells them to an unrelated party (without significant intervening use or material improvement) and provides the donor a statement that the donor's deduction cannot exceed the proceeds shown.

When required, a taxpayer must obtain a qualified appraisal before a deduction based on FMV can be claimed, even though there may be other evidence supporting the FMV. In *Hewitt*, the taxpayer donated nonpublicly traded stock for which there were a number of arms-length trades around the time of the contribution, enabling the taxpayer to approximate its value. The IRS did not dispute the claimed values. However, a qualified appraisal was not obtained and the Section B appraisal summary of Form 8283 was not completed (even though it was required). The court ruled in favor of the IRS in restricting the deduction to the taxpayer's adjusted basis in the stock.

Appraisal Requirements. The 2006 Pension Act expanded the definition of a qualified appraisal for qualifying charitable property and placed in the statute a requirement that the appraisal must be done by a *qualified appraiser* in accordance with generally accepted appraisal standards (for example, in accordance with principles developed by the Appraisal Standards Board of the Appraisal Foundation).

A *qualified appraiser* is an individual with verifiable education and experience in valuing the relevant type of property being appraised. These requirements are satisfied if the individual has *either*: successfully completed professional or college-level coursework in valuing the relevant type of property and has at least two years of experience in valuing such property; *or* has earned a recognized appraisal designation for the relevant type of property. A *recognized appraisal designation* means one awarded by a recognized professional appraiser organization on the basis of demonstrated competency (e.g., Member of the Appraisal Institute, Section Residential Appraisal, Senior Real Estate Appraiser, or Senior Real Property Appraiser).

However, the following individuals cannot be qualified appraisers for the appraised property:

1. an individual who receives an appraisal fee based to any extent on the appraised value of the property,
2. the donor,
3. except in limited circumstances, a party to the transaction in which the donor acquired the property,
4. the donee,
5. certain persons related to, or regularly used as an appraiser by, persons 1–4, or
6. has been prohibited from practicing before the IRS at any time during the three-year period ending on the date of the appraisal.

A *qualified appraisal* is a document prepared in accordance with generally accepted appraisal standards and that satisfies several other criteria. *Generally accepted appraisal standards* means the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation.

Notice 2006-96 provides transitional guidance on the new definitions of qualified appraisal and qualified appraiser until proposed regulations are finalized. Practitioners are urged to review the rules and terms in this notice and to watch for these proposed regulations to become final.

Pursuant to IRS Notice 2006-96, an appraisal will be treated as a qualified appraisal if it complies with the requirements of the current regulations in Reg. 1.170A-13(c). Among these requirements are that the appraisal must be done by a qualified appraiser no earlier than 60 days before the contribution and received by the donor no later than the due date (including extensions) of the return on which the charitable deduction is first claimed. IRS Pub. 561, "Determining the Value of Donated Property," contains additional information concerning valuation and appraisals, and Reg. 1.170A-13(c)(3) provides the detailed requirements of an appraisal.

IRS Notice 2006-96 provides that an appraiser is considered to have met the minimum education and experience requirements if, (1) for real property, the appraiser is licensed or certified for the type of property being appraised in the state in which the appraised real property is located, or (2) for other than real property, the appraiser has (a) successfully completed college or professional-level coursework that is relevant to the property being valued; (b) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued; and (c) fully described in the appraisal the appraiser's education and experience that qualify the appraiser to value the type of property being valued.

The appraiser's fee is not deductible as a charitable contribution but can be deducted as a miscellaneous itemized deduction subject to the 2% of AGI limit.

Example 3C-3 Contribution of capital gain property—filing Form 8283.

During the year, John contributed a painting valued (by appraisal) at $6,000 to Hope Museum (a 50% charity) which he had purchased in 1995 for $500. He also contributed a piece of pottery purchased in 1997 for $50. John obtained written estimates of the pottery's current selling price to arrive at its FMV of $900. He received a receipt from the museum for both of these gifts when they were made.

John is entitled to a $6,900 contribution deduction, subject to the special 30% of AGI limitation because it is a gift of capital gain property to a 50% charity.

Publicly Traded Securities. An appraisal is not required for contributions of publicly traded securities that have market quotations readily available. For this purpose, market quotations are readily available if the security is: (1) listed on the New York Stock Exchange, the NASDAQ, or any other exchange where quotations are published on a daily basis, (2) regularly traded in the national or regional over-the-counter market, or (3) a share of a mutual fund where quotations are published on a daily basis throughout the U.S. These publicly traded securities are reported only on Section A of Form 8283, regardless of the amount of the donation. In addition, certain securities are treated as having market quotations readily available if they are listed on an interdealer quotation system and the requirements outlined in Reg. 1.170A-13(c)(7)(xi)(B) are met. While no appraisal is required for these securities, they must be reported on Form 8283, Section B, Part I, and the donee organization must complete and sign Section B, Part IV (the donee acknowledgment).

Contributions of Artwork of $50,000 or More. Taxpayers can request an IRS Statement of Value (which can be relied on when preparing returns) for contributions of art with an appraised value of $50,000 or more. (Under limited circumstances, the IRS may issue such a statement for items appraised for less than $50,000.) The request must be made before the return first claiming the contribution deduction is filed. Rev. Proc. 96-15 (modified by Ann. 2001-22) provides a detailed list of what must be included with the request, including a user fee of $2,500 for up to three items, plus $250 for each additional item.

Written Notification Requirement for Gifts of Certain Intellectual Property

The deduction for contributions of certain intellectual property is limited to the lesser of the donor's basis or FMV. The donor may also be allowed an additional deduction (in the year of the donation and subsequent years) based on a percentage of the donee's income allocable to the intellectual property. However, to qualify for the additional deductions, the donor must inform the donee at the time of the contribution that the donor intends to treat the contribution as a qualified intellectual property contribution. A donor will satisfy this notification requirement if the

donor delivers or mails to the donee, at the time of the contribution, a written statement containing the following information:

1. The name, address, and taxpayer identification number of the donor;
2. A detailed description of the qualified intellectual property;
3. The date of the contribution to the donee; and
4. A statement that the donor intends to treat the contribution as a qualified intellectual property contribution.

Charitable Contribution Deduction for Gifts of Certain Property

Determining the Deductible Amount for Gifts of Appreciated Property

Ordinary Income and Short-term Capital Gain Property. The contribution deduction allowed for charitable gifts of appreciated ordinary income property (e.g., property created by the donor or inventory) and short-term capital gain property (i.e., capital assets the taxpayer has held for 12 months or less) is limited to the taxpayer's basis in the property. This rule applies regardless of the type of charity to which the property is contributed.

Long-term Capital Gain Property. The contribution deduction allowed for gifts of appreciated long-term capital gain property (including Section 1231 property) to charities (other than to certain private foundations—see discussion later in this lesson) depends on (1) the type of property contributed and (2) the charity's use of it, as shown in the following table (long-term capital gain property is property held for more than one year):

Type of Property	Use by Donee	Contribution Deduction
Tangible personal property	Related use	FMV; If Section 1231 property, FMV less ordinary income that would have been recaptured if it had been sold for FMV.
	Unrelated use	Basis
Other long-term capital gain property (stocks, mutual fund shares, real estate, etc.)	N/A	FMV; If Section 1231 property, FMV less ordinary income that would have been recaptured if it had been sold for FMV. Also, lesser of FMV or basis for certain intellectual property.

If a partnership makes a charitable contribution of appreciated property (deductible on the partner's individual tax return), the basis of each partner's interest in the partnership is decreased (but not below zero) by his share of the partnership's *basis* (rather than FMV) in the property contributed. The rationale of the ruling should apply equally to partners and S corporation shareholders, but the IRS's position is that an S corporation shareholder reduces basis by the contributed property's FMV rather than its basis.

Qualified Intellectual Property. The deduction for contributions of certain intellectual property is limited to the lesser of the donor's basis or FMV. This limit applies to most intangibles, including patents, copyrights (other than those held by the creator or by a transferee whose basis is determined by reference to the creator's basis), trade names, know-how, and software (other than software that is readily available for purchase and has not been substantially modified). However, the donor may be allowed an additional deduction (in the year of donation and subsequent years) based on a percentage of the donee's income allocable to the intellectual property. (The donee organization must provide notice of the income to the donor on Form 8899.) This additional deduction is limited to the amount by which the sum of the increases based on income from the property exceeds the original deduction. Also, the donor must inform the donee that he or she intends to use this provision.

Special Rules for Tangible Personal Property. As shown in the previous table, the deductible amount of a gift of appreciated tangible personal property is FMV only if the charity uses the property in its exempt function. For example, an educational institution which displays artwork donated to it in its library or uses it for study by art students is deemed to be using the artwork for a related purpose. If a taxpayer donates tangible personal property

to a charitable organization that immediately sells it or uses it for a purpose that is not not related to its exempt purpose, the amount of the deduction must be reduced by the unrealized appreciation (i.e., the amount of the deduction cannot exceed the taxpayer's basis). An unrelated use occurs when property is not used by the organization in the charitable activities for which the organization was granted exempt status.

The FMV deduction of certain related-use property (known as *applicable property*, defined later in this discussion) may be reduced or recaptured if the charitable donee organization disposes of such property within three years of the contribution of the property. *Applicable property* is tangible personal property identified by the charitable donee as related to its exempt purpose and for which a deduction in excess of the donor's basis in the property of more than $5,000 was allowed. However, this adjustment of the deduction is avoided if the charitable donee provides the proper certification regarding the donated property to the IRS (see later discussion regarding this certification).

The reduction or recapture provisions apply when the charitable donee disposes of the applicable property within three years of the date of the gift as follows:

1. *Reduction.* The amount of the deduction for the property is reduced to the donor's basis if the property is disposed of within the same tax year as the year of the donation.

2. *Recapture.* If the charitable donee disposes of the property after the year of donation but within three years of the donation date, the donor must recapture the benefit (the excess of the property's FMV over its adjusted tax basis) as ordinary income. The donor reports the income in the year of disposition.

A specific written certification from the charitable donee organization can serve as the sole exemption to the reduction/recapture rules targeted at applicable property contributions. The certification must confirm to the IRS (and to the donor) that the use of the property was related to its exempt function or that there was intended use at the time of the contribution, which has become impossible or infeasible to implement. The certification must be signed under penalty of perjury by an officer of the organization. The charity must furnish a copy of the certification to the donor (for example, as part of the Form 8282).

Example 3D-1 Contribution of appreciated tangible personal property.

Jane donated a painting worth $50,000 to the Museum of Modern Art, a public charity, on December 5, 2009. She paid $10,000 for the painting 20 years ago. The museum still has the painting at the end of 2009.

Because the painting is the kind normally displayed by the museum, it is reasonable for Jane to believe it will be displayed (which is a related use to the museum's exempt purpose). Therefore, Jane may claim a charitable contribution deduction of $50,000 on her 2009 tax return. If the museum disposes of the painting after 2009 but before December 5, 2012, Jane must include $40,000 ($50,000 FMV deduction in year of gift less $10,000 basis) in her ordinary income in the year in which the museum disposes of the painting.

Valuing Noncash Contributions

Establishing FMV of a charitable contribution of real estate, stock, or financial instruments is generally not an issue for a taxpayer due to the availability of appraisals and market quotes. However, most taxpayers have problems placing a value on clothing and other household items gifted to charity. The burden of establishing FMV is on the taxpayer.

Many taxpayers value clothing and household items as a percentage of the original cost of the item (depending on its condition). However, IRS Pub. 526, "Charitable Contributions," states that the use of such formulas is not acceptable. For used clothing, the prices buyers actually pay in used clothing stores such as consignment or thrift shops can be used. However, if a deduction of more than $5,000 is claimed, the donor must obtain a qualified appraisal or the entire contribution can be disallowed.

Contributions of used clothing and household items that are not in "good" condition or better are completely disallowed. The statute does not define the term "good." The term *household items* means furniture, furnishings, electronics, appliances, linens, and similar items (but not food, paintings, other art objects, antiques, jewelry, gems, or collections). An exception to the general disallowance rule allows deductions for single used household items

that are not in good condition or better if they are valued at more than $500 in a qualified appraisal filed with the return (see "Appraisal Requirements"). Also the IRS is authorized to issue future rules that could completely disallow deductions for certain used clothing and household items that are deemed to have minimal value (such as underwear and socks) regardless of condition. For affected contributions by a partnership or S corporation, the restrictions apply at the entity level, and deductions are disallowed at the partner or shareholder level. For further assistance, taxpayers should review IRS Pub. 561, "Determining the Value of Donated Property."

Permitting Charity to Use Property. A taxpayer who permits a charity to use his property without charge (or at a minimal charge) is not entitled to a deduction. The taxpayer is deemed to have made a contribution of a partial interest in property, which is a nonqualifying contribution. This means that a donor who allows a charity to auction off the use of property (such as a vacation home) receives no donation for the fair rental value of that property. (Also, the successful bidder's donation is limited to the amount by which the bid exceeds the fair rental amount.) Likewise, granting a charity a license to use a patent is a nondeductible donation of a partial interest in the property.

Gift of Property That Has Decreased in Value

The contribution deduction allowed for charitable gift of property that has decreased in value is limited to its FMV at the time of contribution. Furthermore, the loss is not deductible. Thus, it is generally better (from a tax standpoint) to sell the property, recognize the loss (assuming it is otherwise deductible), and then donate the proceeds to charity. (These rules apply regardless of the type of charity or property contributed.)

Example 3D-2 Contribution of property that has decreased in value.

Haley owns a piece of investment real estate worth $50,000, which she purchased 10 years ago for $70,000. She wants to donate the property to her local community college.

If Haley donates the property to the college, her charitable contribution deduction will be $50,000, and no loss deduction will be allowed. However, if Haley sells the property for $50,000, she will recognize a long-term capital loss of $20,000. Then, if she donates the $50,000 cash proceeds to the college, she will still be entitled to a $50,000 charitable contribution deduction.

Stock Gifts to a Private Foundation

The contribution deduction allowed for a gift of any type of appreciated property to a private foundation [other than a private operating foundation, as described in IRC Sec. 4942(j)(3), common fund private foundation, or conduit private foundation] is generally limited to the taxpayer's basis. However, donors can deduct the FMV of qualified appreciated stock given to a private foundation.

Qualified appreciated stock is corporate stock (1) that is long-term capital gain property and (2) for which market quotations are readily available on an established securities market (the definition excludes closely-held stock). Even though quotations may be readily available from other sources (i.e., a brokerage firm), the quotations must be readily available *on an established securities market*. Qualified appreciated stock does not include contributions by a taxpayer and his family that exceed (when combined with all of their prior contributions of such stock) more than 10% of the value of all the outstanding stock of such corporation.

Gifting Nonstatutory Stock Options

The tax consequences of gifting nonstatutory options are somewhat unclear because typically such options have no readily ascertainable FMV. Neither the Code nor regulations describe the tax consequences of gifting a stock option that does not have a readily ascertainable FMV. The IRS concluded that an employee who donated his nonstatutory options to charity would not recognize any income or gain when the option was donated to the charity. However, the IRS also ruled that if the employee was still living at the time the charity exercised the option, the excess of the optioned shares' FMV on the date of exercise over the option's exercise price would be taxed as compensation income to the employee, and this income would be subject to income tax and FICA withholding. The same results would apply if the option is exercised after the employee's death except that the income (taxable to the employee's estate or other beneficiary) would not be subject to income tax withholding.

The IRS further concluded that the employee was not entitled to receive a charitable deduction at the time the option was donated because he retained the right to veto the charity's exercise of the option. However, according to the IRS's conclusion in a related ruling, when the charity exercises the option, a charitable deduction is allowed to the employee (equal to the value of the stock the charity receives less the amount spent to exercise the option and pay the employee's withholding taxes). If the exercise occurs after the employee's death, the estate receives the charitable deduction (which will not be reduced by the charity's payment of withholding taxes because none will be required). Thus, if the option is exercised by the charity while the employee is living, the employee's compensation income triggered by the exercise will exceed the value of the charitable deduction by the amount of the withholding taxes paid by the charity. If the exercise occurs after the employee's death, the taxable income and charitable deduction will be the same.

Motor Vehicles, Boats, and Airplanes (Qualified Vehicles)

There are strict rules regarding claimed charitable deductions exceeding $500 for donations of motor vehicles, boats and airplanes (qualified vehicles). The amount of the deduction depends on how the charity uses the vehicle.

If a charity sells a qualified vehicle donated by the taxpayer without any *significant intervening use* of or *material improvement* to the vehicle (these terms are defined later in this discussion), the taxpayer's charitable deduction is limited to the gross proceeds from the sale. Consequently, in this situation, the FMV of the donation is irrelevant. However, a taxpayer may claim a deduction for the FMV of a donated qualified vehicle if the charity sells the vehicle to a needy individual at a price significantly below FMV or gives the vehicle to a needy individual, only if the sale or gift directly furthers a charitable purpose of the charity of helping the poor, distressed, or underprivileged in need of transportation. Vehicles sold at auction do not qualify for this rule. Use of the proceeds from the sale of the donated vehicle to help a needy individual, as opposed to selling or transferring the vehicle directly to the individual, is not considered in furtherance of the charity's charitable purpose.

If the charity intends to and actually does significantly use the vehicle to further its charitable activities or if it makes material improvements to the donated vehicle, the taxpayer is not subject to the gross proceeds limitation, but the claimed deduction for the donation of the qualified vehicle is then limited to its FMV at the time of donation.

A taxpayer claiming a deduction for the FMV of a qualified vehicle must be able to substantiate that value. FMV is defined in Reg. 1.170A-1(c)(2) as the price at which the property would change hands between a willing buyer and a willing seller with neither party having any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. A donor may use an established used vehicle pricing guide to determine the FMV of a donated vehicle, but only if the guide lists the sales price for a vehicle that is the same make, model, and year, sold in the same area, in the same condition, with the same or substantially similar options or accessories, and with the same or substantially similar warranties or guarantees as the donated vehicle. Otherwise, the donor must use some other method that is "reasonable under the circumstances" to determine FMV. A dealer retail value listed in a used vehicle pricing guide will not be acceptable for this purpose. However, an interactive online resource such as **www.kbb.com** can be used to derive the private party sale FMV amount.

To constitute *significant intervening use*, a charitable donee organization must actively use the qualified vehicle to substantially and significantly further its regularly conducted charitable activities. Incidental use is not a significant intervening use. For example, using a vehicle to drive over 10,000 miles in a year to deliver meals to needy individuals constitutes significant use. Driving the vehicle only a few times a year for the same purpose would be incidental use.

A charity is treated as making a *material improvement* to a qualified vehicle if it makes major repairs or improvements that significantly increase the value of the vehicle. Examples of improvements that would not be considered material include cleaning the vehicle, painting, minor repairs including repairing dents or scratches, and installation of theft deterrent devices.

In all cases, no deduction is allowed for the charitable contribution of a qualified vehicle for which a claimed value exceeds $500 unless the contribution is substantiated with a contemporaneous written acknowledgment from the

donee charity. The acknowledgment, which will generally be provided to the donor on Form 1098-C, must be included with the taxpayer's return on which the deduction is reported, and must contain the following information:

1. The name and taxpayer ID number of the donor.

2. The vehicle ID number.

3. The date of the contribution.

4. If the charity sells the qualified vehicle without any significant intervening use or material improvement in a sale that is not to a needy individual at a price significantly below FMV:

    a. the date the qualified vehicle was sold,

    b. a certification that the vehicle was sold in an arm's length transaction between unrelated parties,

    c. the gross proceeds from the sale, and

    d. a statement that the deductible amount may not exceed the amount of the gross proceeds.

5. If the charity intends to use the vehicle to further its charitable activities (significant intervening use) or intends a material improvement to the qualified vehicle:

    a. a certification and detailed description of the intended significant intervening use and the intended duration of the use, or the intended material improvement by the charity, and

    b. a certification that the vehicle will not be sold before completion of the use of improvement.

6. If the charity sells the qualified vehicle to a needy individual at a price significantly below FMV or gives the vehicle to a needy individual, whereby the sale or gift directly furthers a charitable purpose of the charity of helping the poor, distressed, or underprivileged in need of transportation:

    a. a certification that the charity will sell the qualified vehicle to a needy individual at a price significantly below FMV (or, if applicable, that the charity will give the vehicle to a needy individual), and

    b. that the sale (or gift) will be in direct furtherance of the charity's regular charitable purpose of relieving the poor, distressed, or underprivileged in need of transportation.

The acknowledgment is considered contemporaneous if the charitable donee furnishes the acknowledgment to the donor taxpayer within 30 days (1) after the date of sale for item 4, or (2) after the date of contribution for items 5 or 6.

If a charity sells a donated used vehicle by conducting a raffle, the raffle ticket proceeds do not count as the gross proceeds from sale. The IRS asserts the deduction for a raffled vehicle is generally limited to the lower of (1) $500 or (2) the vehicle's FMV. However, if the charity makes significant intervening use of the vehicle or makes material improvements (as defined earlier), the donor can deduct the raffled vehicle's full FMV.

Conservation Contributions

IRC Sec. 170(h) allows a charitable contribution for the FMV of a qualified conservation contribution. IRC Sec. 170(h)(1) defines this as a contribution of a qualified real property interest to a qualified organization that uses the easement exclusively for conservation purposes. IRC Sec. 170(h)(2) further clarifies that a real property interest for this purpose includes a perpetual restriction on the use of real property. The landowner does not give up ownership, control, or enjoyment of the land. The easement only restricts what can be done on or to the land. In the typical case, a perpetual conservation easement is given to a qualified conservation organization as described in Reg. 1.170A-14(c)(1) (e.g., a state agency charged with preserving natural resources).

There are four general types of conservation purposes: (1) outdoor recreation, (2) saving natural habitat (*Glass*), (3) preservation of open spaces, and (4) historical value. The amount of the deduction for a contribution of a qualified conservation easement is its FMV at the time of the contribution. If there are a substantial number of sales of similar easements (highly unlikely), FMV is determined by comparable sales. In the more likely case, when comparable sales are not available, the FMV of the easement is the difference between the FMV of the land without the easement and its FMV with the easement. As with any valuation, it is important to obtain an appraisal that will withstand IRS scrutiny.

If the donor receives, or is likely to receive, more financial or economic benefits than those provided to the general public as a result of the contribution, no charitable deduction is allowed. Furthermore if the conservation easement has no material effect on the value of the land subject to the easement or if it enhances, rather than reduces the value of the land, no charitable deduction is allowed.

Example 3D-3 Valuing a lifetime contribution of a qualified conservation easement.

Vera Wood owns a ten-acre tract of undeveloped land that she purchased four years ago for $30,000. The land now has an FMV of $15,000 per acre. Vera grants Denton County a perpetual easement for conservation purposes to use and maintain eight of the ten acres as a public park and to restrict any future development thereon. These restrictions reduced the value of the eight acres to $1,000 per acre. However, by restricting future development on this portion of her land, Vera has ensured that the two remaining acres will always be bordered by parkland. Thus, the value of these two acres increased to $22,500 each.

If the eight acres represented all of Vera's land, the FMV of the easement would be $112,000, an amount equal to the value of the land before the easement (8 × $15,000 = $120,000) less its value encumbered by the easement (8 × $1,000 = $8,000). However, because the easement only covered a portion of Vera's land, the amount of the deduction is reduced to $97,000 ($150,000 − $53,000). This is the difference between the value of the entire tract before ($150,000) and after [(8 × $1,000) + (2 × $22,500)] granting the easement.

AGI Percentage Limitations for Qualified Conservation Contributions. There are temporary enhanced deduction rules for qualified conservation contributions by individuals to Section 170(b)(1)(A) charitable organizations ("50% charities"). These rules apply to contributions made in tax years beginning in 2006 through 2009. The maximum allowable deduction for qualified conservation contributions is 50% of AGI (versus only 30% under the normal rules). The donor's other allowable contributions are counted first against the 50%-of-AGI base. Qualified conservation contributions that cannot be deducted in the donation year can be carried forward for 15 years (versus only five years under the normal rules). For a qualified farmer or rancher, qualified conservation contributions for donated farm or ranch real property are deductible up to 100% of AGI. However, the donation must include a usage restriction stating that the property must remain available for agricultural or livestock production.

A qualified farmer or rancher is defined as a taxpayer whose gross income from farming is greater than 1/2 of the gross income for the taxpayer for the year. Gross income from farming for this purpose is the typical definition of income from raising agricultural or horticultural commodities, including livestock, but it also extends to the planting, raising, or cutting of trees.

Example 3D-4 Carryover of qualified conservation contribution.

John makes a qualified conservation contribution of property with a fair market value of $80,000 (property appraised at $300,000 before easement restrictions and $220,000 after the conservation easement). John also contributes $60,000 of cash charitable contributions subject to the 50%-of-AGI limit. His AGI contribution base for the year of these contributions is $100,000.

John is allowed a charitable deduction of $50,000 in the current taxable year for the non-conservation contributions (50% x $100,000 contribution base) and is allowed to carry over the excess $10,000 of other charitable contributions for up to five years. Although no part of the qualified conservation contribution is currently deductible, the entire $80,000 qualified conservation contribution ($300,000 – $220,000) is eligible for carryforward for up to 15 years, subject to the annual 50%-of-AGI limit.

Example 3D-5 Qualified conservation contribution by farmer or rancher.

Assume the same facts as in Example 3D-4, except that John's qualified conservation contribution relates to agricultural land. If John is a qualified farmer or rancher, he is allowed to deduct, in addition to the $50,000 deduction for non-conservation contributions, an additional $50,000 for the qualified conservation contribution. The $10,000 of non-conservation charitable contributions ($60,000 – $50,000) may be carried over for up to five years, while the $30,000 ($80,000 – $50,000) of excess qualified conservation contribution can be carried forward for up to 15 years, subject to the 100% of AGI limitation.

Bargain Sale Rules

The sale of appreciated property to a charity for less than FMV is treated as both a sale and a charitable gift. Accordingly, the taxpayer must proportionately allocate the property's basis to the sale portion based on the ratio of the amount received (sales price) to the property's FMV. This prevents the taxpayer from allocating the property's entire basis to the sale portion of the gift in an attempt to minimize or eliminate any gain. The donor's charitable contribution deduction for the property is the FMV less the amount realized (i.e., selling price) less any ordinary or short-term capital gain the taxpayer realized but did not recognize from the contribution.

Example 3D-6 Property sold to charity for adjusted basis.

Bob sells unimproved real estate that is currently worth $90,000 (and held for three years) to his church for $3,000 (his basis in the property). Under the bargain sale rules, $100 ($3,000 selling price ÷ $90,000 FMV × $3,000 basis) of the property's basis is allocated to the sale. Thus, Bob recognizes a $2,900 long-term capital gain as a result of the sale. He also receives an $87,000 charitable contribution deduction ($90,000 FMV − $3,000 selling price).

Variation: If the land was held for less than 12 months, the $2,900 gain would be short-term, and Bob's charitable contribution deduction would be limited to $2,900 ($90,000 FMV − $3,000 selling price − $84,100 short-term capital gain not recognized).

Donating Debt-encumbered Property. Donating debt-encumbered property generally results in both recognized gain and a charitable gift deduction for the taxpayer. A deemed sale results from the transfer with sale proceeds equaling the amount of the debt, whether or not the charity assumes or makes payment on the debt. The charitable deduction is its FMV less any ordinary income and short-term capital gain that the taxpayer would have recognized had the property been sold rather than gifted to charity less the amount realized (i.e., the deemed sale proceeds). If the taxpayer remains liable on the mortgage, additional charitable contribution deductions are available as the taxpayer makes payments on the debt.

Example 3D-7 Donating debt-encumbered property.

Alice donates unimproved real property to her church. The property has a FMV of $25,000 and Alice's adjusted basis in it is $15,000. The property is encumbered by an outstanding mortgage of $10,000. To Alice, the property was a capital asset she held more than one year.

The outstanding mortgage is treated as an amount realized, so the transfer is subject to the bargain sale rules. Accordingly, Alice recognizes a long-term capital gain of $4,000 based on sales proceeds of $10,000 and allocable basis of $6,000 [$15,000 adjusted basis × ($10,000 amount realized ÷ $25,000 FMV of the property)]. Her charitable contribution deduction is $15,000: the difference between the FMV of the property ($25,000) and the amount realized ($10,000 mortgage).

Deduction for Payments That Entitle a Taxpayer to Receive Goods or Services in Return (Quid Pro Quo Contributions)

Individuals often make donations entitling them to receive goods or services, such as tickets to balls, banquets, or shows. Such contributions are referred to as quid pro quo contributions. Under a two-part test, a quid pro quo contribution is deductible to the extent:

1. it exceeds the FMV of the goods or services received in return for the payment, and *provided*

2. the person making the payment intended to make a charitable contribution (i.e., intended to pay more than FMV for the goods or services to benefit charity).

Exceptions for Insubstantial Benefits

Generally, a good faith estimate of the value of noncommercially available goods or services may be made by reference to the FMV of similar or comparable goods or services or any other reasonable method. However, the benefits received may be insignificant in relation to the contribution, thus making them impractical to value. To alleviate the burden of determining the FMV of these benefits, IRS guidelines allow charities to treat items of token benefit as having insubstantial FMV. When benefits have insubstantial value, the full amount of the individual's payments to the organization will be allowed as a charitable contribution deduction.

For 2009 contributions, benefits received will be considered to have insubstantial FMV if the payment occurs in a fund-raising campaign and:

1. the FMV of the benefits received is not more than 2% of the payment or $95, whichever is less; or

2. the payment is $47.50 or more, and the only benefits received are token items (mugs, calendars, bookmarks, etc.) whose cost does not exceed $9.50.

Rev. Proc. 92-49 allows charitable solicitations that are accompanied by free, unordered, and low-cost items within the meaning of IRS Sec. 513(h)(2). The items must be accompanied by a request for a donation and include a statement that the donor may keep the items even if he does not make a contribution.

Additionally, the following membership benefit rights can be ignored when an organization receives a membership contribution of $75 or less from a donor:

1. Benefits the donor can exercise frequently during the membership period such as free or discounted admission or parking or discounts on purchases of (or preferred access to) goods or services. However, a right to purchase tickets for seating at an athletic event in a charity's athletic stadium is specifically not included in the rights that can be ignored.

2. Benefits that provide admission to events open only to members, if the direct cost per person for each event is within the limits established for low-cost articles under IRC Sec. 513(h)(2) ($9.50 for 2009).

Reporting Requirements

Organizations that receive quid pro quo contributions exceeding $75 (regardless of the deductible amount) must provide a written statement to the donor stating that the contribution deduction is limited to the excess of the contribution over the value of the goods or services received. The charity must also provide a good faith estimate of the goods or services given to the donor. The disclosure required under these rules is separate from the acknowledgments required under the substantiation rules discussed earlier; however, one statement may satisfy both requirements.

These disclosures can be made by the charity either when the contribution is solicited or when it is received. The disclosures must be made in a manner reasonably likely to be noticed by the donor. Disclosure is not required when an item of insubstantial FMV (see earlier discussion) or an intangible religious benefit (for example, admission to a religious service) is received.

Determining the Deductible Amount of Quid Pro Quo Contributions

The disclosure rules for quid pro quo contributions do not affect their deductibility. That is, the amount deductible is limited to the value of the contribution less the value of the goods or services received in return, even if the contribution is less than $75. Goods or services means cash, property, services, benefits and privileges. The deduction is also limited even if the taxpayer does not use the tickets or other privileges received, unless they are *actually* returned to the charitable organization.

Example 3E-1 Purchasing tickets to a charitable event.

Bob purchased two $100 tickets to a symphony concert for the purpose of raising funds for the Children's Hospital. The actual value of each ticket is $30. Thus, Bob's charitable contribution to the hospital is $140 ($200 price of tickets − $60 actual value of tickets).

Variation 1: Assume that Bob had no intention of using the tickets when he purchased them, and he did not, in fact, attend the concert. In this case, Bob's charitable contribution is still $140; the fact that the tickets were not used does not entitle Bob to any greater right to a deduction than if he had used the tickets. The same result would follow had Bob given the tickets to another individual.

Variation 2: Assume instead that Bob paid for the tickets but returned them to the Children's Hospital (i.e., he wanted to support the Hospital but had no intention of attending the concert). By doing so, Bob can deduct the entire $200 cost of the tickets.

Example 3E-2 Contribution with preferential treatment.

Ralph made a $5,000 charitable contribution to the Arts Museum during the year. As part of this gift, he receives advance notification of all events, premium seating at lectures, valet parking and admission to a free lunch and lecture series. The museum estimates the value of the premium package is $1,500. On his tax receipt this value is declared. Ralph may deduct $3,500 on his tax return for his gift to the museum.

A special rule applies to contributions made to colleges or universities when the donor receives (directly or indirectly) the right to purchase tickets for athletic events at the institution's stadium. Here, the donor can only deduct 80% of the contribution. In Ltr. Rul. 200004001, the IRS applied this same rule to the right to lease skyboxes in college and university stadiums. Any portion paid for the actual purchase of tickets (not the right to purchase tickets) is not deductible as a charitable contribution, but may be deductible as business gifts or an entertainment expense.

Example 3E-3 Donation providing preferential rights to college athletic tickets.

John paid $5,000 to State University for the right to purchase six 50-yard line tickets to its football games. John paid an additional $1,500 to purchase those tickets at their face value. Under the special rule for certain donations to colleges and universities, John can only deduct 80%, or $4,000, of the $5,000 payment. The $1,500 payment for tickets is not deductible as a charitable contribution.

Raffle Tickets. Raffles often are conducted to raise funds for charity. Typically the taxpayer pays an amount (purchasing a raffle ticket) for a chance to win a valuable prize. The proceeds from the sale of raffle tickets are kept by the charity and used to fund its charitable activities. Amounts paid for chances to participate in raffles, lotteries, or similar drawings or to participate in other contests for valuable prizes are not gifts and do not qualify as a deductible charitable contribution. To be a gift there must be a voluntary payment of money or the transfer of property with no expectation of financial benefit commensurate with the amount of the transfer. The taxpayer is deemed to have received full consideration when purchasing a chance to win a valuable prize; i.e. the chance itself is the consideration.

Donations to Child's School. Prior to the substantiation rules discussed previously, taxpayers sometimes attempted to convert nondeductible school tuition into charitable contributions. Rev Rul 83-104 provides guidance on some of the factors the IRS considers for this issue. Now, any school would have to agree with the taxpayer if any gift was made in addition to tuition payments evidenced by a contemporaneous receipt. If there are still questions, *Sklar* walks through the issues that the IRS looked at the school tuition and contribution issues.

Claiming a Contribution Deduction Using Life Insurance

Naming the Charity as Beneficiary

If an individual names a charity as beneficiary of a life insurance policy that the individual owns, no income tax deduction is available because the donation is not a complete interest in the policy. Thus, an individual may fulfill his charitable intentions by naming a charity as beneficiary of a life insurance policy; however, the individual will not receive the benefit of a lifetime income tax deduction.

Transferring Policy Ownership to Charity

The outright donation of a life insurance policy to a charitable organization generates an income tax deduction generally equal to the cost basis in the contract. Because the sale of an insurance policy generally results in ordinary income to the extent that the sales price exceeds the owner's adjusted basis, IRC Sec. 170(e)(1)(A) effectively limits the deductible amount for a donation of an insurance policy to the donor's cost basis (i.e., cost of premiums) in the contract. In the case of a new policy (the assignment occurs on the day the policy is taken out), the deduction is equal to the donor's cost basis (i.e., initial premiums) in the contract. Future premiums paid by the donor also will be deductible for income tax purposes.

Contributions of life insurance policies to charity, or premium payments on life insurance policies owned by the charity are subject to the AGI limitations discussed earlier. The donation of a life insurance policy to a charity is subject to either the 50% or 30% of AGI limitation, depending upon the type of charitable donee. Premium payments made directly to the insurance company are considered made "for the use of" the charity, and are deductible up to 30% of AGI. Conversely, contributions directly to the charity (which then pays the premiums to the insurance company) are limited to 50% of AGI. To avoid the 30% AGI limitation on contributions, donors should make cash gifts to charity to pay the premium on a life insurance policy rather than paying the insurance company directly. (Also, making payments to the charity rather than directly to the insurance company will help ensure the taxpayer receives a written acknowledgment from the charity when necessary to substantiate the charitable donation.) In addition, a written acknowledgment must also be received from the charity on the contribution of the policy to the charity.

Example 3F-1 Making a charitable contribution using life insurance.

Tim owns a $100,000 life insurance policy (face amount) on his life with a cash surrender value of $30,000. He has paid $20,000 in premiums on the policy. If Tim makes an outright donation of the policy to his church, he can deduct $20,000, limited to 50% of AGI, as an itemized deduction. If he continues to pay the premiums directly to the insurance company after the donation, he can deduct those premiums in the years they are paid up to 30% of AGI (in addition to the $20,000 up-front deduction). Alternatively, if he makes cash donations to his church and the church uses the funds to pay the premiums on the donated policy, the donations for the premium payments are subject to the more liberal 50% of AGI limitation.

Variation: If Tim had donated the policy to his best friend's nonoperating private foundation instead of his church, the $20,000 up-front charitable deduction would be limited to 30% of AGI.

Determining When a Contribution Is Considered Made and Deductible

General Rules

Ordinarily, a contribution is considered made at the time of *delivery*. If payment is made by check, the contribution is considered made on the date of delivery or mailing, assuming the check subsequently clears. Contributions charged to a credit card are deductible in the year the charge is made, even though not paid by the donor until the following year.

Credit Card Rebates

A charitable contribution deduction is allowed for the portion of rebated credit card purchases that are transferred to a qualified charity. However, unlike contributions charged to a credit card, these rebate contributions are not

actually made by the use of the card. Rather, they are held by the credit card company in a custodial account for disbursement to charity. Accordingly, the charitable contribution is made (and deductible) when the rebates are transferred to the designated charity. To be deductible, the taxpayer must have the choice of donating the rebate or receiving it himself. Also, a credit card company's automatic transfer of a certain percentage of the taxpayer's charges to charity is nondeductible, even if the taxpayer designates the charity, since that amount was never available to the taxpayer. Similar to credit card rebates, rebates from a web-mall vendor that the taxpayer irrevocably chooses to donate to charity, rather than receiving them in cash, are deductible.

Gifts of Stock

If a taxpayer delivers or mails a properly endorsed stock certificate to a charitable donee, the donation is considered made on the date of delivery to the charity or, if mailed, on the date of mailing. If the donor delivers the stock certificate to his bank or broker (as the *donor's* agent) or to the issuing corporation or its agent, the contribution is completed when the stock is transferred on the books of the corporation. In one case, the gift was considered to be complete when stock registered in street name (i.e., in the name of the brokerage firm) was transferred on the books of the stockbroker. However, in another case, when the stock was delivered to a broker acting as the agent of the *donee*, the contribution was effected without regard to the time the transfer of ownership was recorded on the corporation's books. If the donor retains a power to revoke the gift before its actual transfer, the gift is not complete until it is actually transferred.

Example 3G-1 Directing a stockbroker to transfer shares.

On December 15, 2009, Eleanor instructed her broker to transfer 1,000 shares of Microsoft stock (registered in street name) to Faber College. (The broker had physical possession of the stock.) The transfer was completed on January 5, 2010, the date it was transferred on the broker's books.

In this situation, the contribution was *not* made when Eleanor directed her broker to transfer the stock because it was not placed beyond her control until it was transferred on the stockbroker's books. Eleanor cannot claim a deduction for the contribution of the stock to Faber until 2010. The amount of the charitable contribution will be the FMV of the stock on January 5, 2010 (generally, the mean of the highest and lowest quoted selling price on that day).

Tendered Stock. Taxpayers donating stock subject to a cash tender offer can be taxed on the stock gain. For example, in *Ferguson*, the taxpayers donated stock that was subject to a cash tender offer. When the stock was donated, the shareholders and directors of both companies had already agreed to a cash merger and there was no realistic probability that the merger would be abandoned or stopped by a regulatory agency. The Tax Court ruled that the merger was a forgone conclusion at the time of the contribution and that the income associated with contributed stock (i.e., the tender price over the taxpayer's basis) was taxable to the donor.

If a donation is delayed until after there is a "ripening" of the right to receive cash (or other property), as is the case of gifted stock for which a tender offer has been finalized or there has been an adoption of a liquidation or merger plan, the tax deduction may not be maximized. Although the charitable deduction will remain the same, the unrealized appreciation will be deemed to be realized by the donor and subject to income tax under the "anticipatory assignment of income" doctrine.

Deducting Unreimbursed Out-of-pocket Expenses

Although a charitable deduction is not allowed for a contribution of services, unreimbursed out-of-pocket expenditures made in rendering gratuitous services to a charitable organization may be deductible. The expenses are treated as direct payments to the charity, rather than for the use of the organization so they are subject to the 50% of AGI limitation (30% if made to other than a 50% charity). The expenses must be nonpersonal, directly connected with, and solely attributable to the rendering of such services. Thus, expenditures incurred in a charitable purpose, but that primarily benefit the taxpayer, are not deductible as charitable contributions.

Example 3H-1 Out-of-pocket expenses qualifying as a charitable contribution.

Erica, leader of her daughter's Girl Scout troop, takes the group on a weekend camping trip. Provided she is on duty in a genuine and substantial sense throughout the trip, she can claim her out-of-pocket travel expenses as a charitable contribution even though she enjoys the trip.

If Elaine (her sister) goes on the trip to help out (and has only nominal duties or is not required to render services for significant portions of the trip), her travel expenses are not deductible.

Examples of unreimbursed expenses deductible as charitable contributions include uniforms unsuitable for everyday use, equipment, copying charges, office supplies, long distance charges, postage, transportation, or other travel incurred while rendering services for a qualified organization. Travel expenses incurred while away from home, such as meals (subject to the 50% limitation) and lodging are deductible only if there is no significant personal pleasure, recreation, or vacation in the travel and the services performed are substantial. In *Field*, deductions were denied for travel expenses incurred as a volunteer to a symphony orchestra on an overseas tour. The court held that the expenditures were primarily personal (i.e., sightseeing).

The cost of child care while performing services for a charitable organization is not deductible, even if the volunteer work cannot be performed without the expense.

Generally, the use of an auto for charitable purposes is deductible as a charitable contribution at the rate of $.14 per mile. Alternatively, the cost of gas and oil directly related to the use of the auto for volunteer services to a charitable organization are deductible; general expenses such as depreciation, lease payments, license and registration fees, and insurance are not deductible. Parking fees and tolls incurred are deductible whether the standard mileage rate or actual expense method is used.

SELF-STUDY QUIZ

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

11. In 2009, Judy gave her daughter's elementary school land that had been held for investment for 15 months and doesn't plan to deduct the tax basis of the property. To what type of charitable contribution deduction limitation is Judy subject?

    a. The 50% limitation.

    b. The "regular" 30% limitation.

    c. The "special" 30% limitation.

    d. The 20% limitation.

12. Hank donated $15,000 cash to the Immaculate Conception Church. Hank also donated $10,000 cash to a local veteran's organization. Hank's AGI for 2009 is $30,000. How much can Hank deduct in 2009?

    a. $9,000.

    b. $15,000.

    c. $24,000.

    d. $25,000.

13. Which of the following is required when a taxpayer makes cash contributions of more than $250?

    a. A cancelled check.

    b. A receipt from the charity showing the name of the donee, and the date, and amount of the contribution.

    c. A written acknowledgment from the charity with the amount donated noted, as well as whether or not the donor received goods or services in return.

14. In 2009, Roger is looking for someone to appraise a personal property contribution he believes is worth more than $5,000. Choose the appraiser that would be considered a qualified appraiser by the IRS.

    a. Alex: Received an appraisal designation from the Appraisal Institute and has performed appraisals for one year.

    b. Minnie: Regularly performs appraisals for compensation but does not have formal education in appraising property.

    c. Jose: Has worked for a firm performing 100 appraisals a month for three years, and he received his appraisal designation from the American Society of Appraisers.

    d. Brian: Received his appraisal designation in 2005; in 2009, he was prohibited from practicing before the IRS for the 2009 tax year.

15. Brent is donating a qualified vehicle to the United Way for their yearly auction. They intend to sell the vehicle to the highest bidder. Guests of this auction consist of CEOs from various multimillion dollar companies. What amount will Brent be able to deduct for his charitable contribution deduction?

    a. His basis in the vehicle.

    b. The original cost of the vehicle.

    c. The FMV at the time of donation.

    d. The gross proceeds from the sale of the vehicle.

16. In which of the following scenarios is the taxpayer able to deduct a loss and a charitable deduction?

    a. Alan donates $100,000 every year to the local hospital.

    b. Vince owns property that he purchased five years ago for $20,000. Today, the property is worth $30,000. He decides to donate the property to his church.

    c. Carla owns a piece of real estate investment that she purchased 15 years ago for $60,000. Today, the property has a FMV of $57,000. At the end of this year she donated the investment to her local high school.

    d. George bought a piece of property ten years ago for $20,000. Today, the property is worth $5,000. He sold the property for $5,000 then donated the proceeds to the United Way.

Use the following information for Questions 17 & 18:

Mary is donating an unimproved house to her church. The property was a capital asset she had held for a little over two years. The following data relates to the donation.

Mary's adjusted basis	$26,000
Property's FMV	$47,000
Outstanding mortgage	$12,000
Original cost	$45,000

17. What amount can Mary claim as her charitable contribution deduction amount?

    a. $35,000.

    b. $26,000.

    c. $47,000.

18. When applying bargain sale rules, what amount is considered Mary's allocable basis?

    a. $0.

    b. $6,630.

    c. $12,000.

19. Mike purchased four $200 tickets to a hockey game for the purpose of raising funds for the Muscular Dystrophy Association (MDA). The actual value of each ticket is $40. Mike returned one ticket to the MDA. He and a friend used two tickets to attend the hockey game. The third ticket remained unused because another friend cancelled at the last minute. What is Mike's charitable contribution to the MDA?

    a. $640.

    b. $680.

    c. $720.

    d. $800.

20. All of the following result in a charitable contribution for 2009, **except:**

    a. A taxpayer delivers to a charity a check for $2,500 on December 27, 2009.

    b. A taxpayer mails an endorsed stock certificate to a charitable donee on December 31, 2009.

    c. A taxpayer charges a contribution to a credit card on December 25, 2009, and pays the credit card bill on January 6, 2010.

    d. A taxpayer directs his or her broker to transfer stock to a charity on December 20, 2008; the transfer was completed on the broker's books January 8, 2010.

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.)**

11. In 2009, Judy gave her daughter's elementary school land that had been held for investment for 15 months. Judy does not plan to deduct the tax basis of the property. Select the type of charitable contribution deduction limitation applicable in this scenario. **(Page 117)**

    a. The 50% limitation. [This answer is incorrect. Gifts to "50% charities" other than capital gain property qualify for the 50% limitation.]

    b. The "regular" 30% limitation. [This answer is incorrect. The "regular" 30% limitation applies to gifts of property, cash, and gifts *for the use of* any non- "50% charities."]

    c. The "special" 30% limitation. [This answer is correct. Judy donated capital gain property to a "50% charity." Because it states she won't be deducting the tax basis for the property, under the Internal Revenue Code, this donation is subject to the "special" 30% limitation.]

    d. The 20% limitation. [This answer is incorrect. The 20% limitation applies to gifts of capital gain property to non-50% charities.]

12. Hank donated $15,000 cash to the Immaculate Conception Church. Hank also donated $10,000 cash to a local veteran's organization. Hank's AGI for 2009 is $30,000. How much can Hank deduct in 2009? **(Page 117)**

    a. $9,000. [This answer is incorrect. Hank donated to both a "50% charity" and a non- "50% charity." This amount represents the 30% limitation being applied to Hank's AGI based on the $10,000 donation; it does not take into account the $15,000 donation or the overall 50% limit.]

    b. $15,000. [This answer is correct. Under the Code, the $15,000 to a "50% charity" is considered first when applying the contribution limitations. 50% of Hank's AGI equals $15,000 maximum deduction for the year.]

    c. $24,000. [This answer is incorrect. Taxpayers can deduct 30% donations to the extent the overall 50% limit is not exceeded. After the 50% limitation is applied to the first donation the 30% second donation may be carried over.]

    d. $25,000. [This answer is incorrect. This answer does not take into account the limitations placed on the charitable contribution deduction.]

13. Which of the following is required when a taxpayer makes cash contributions of more than $250? **(Page 121)**

    a. A cancelled check. [This answer is incorrect. A cancelled check can be used to substantiate donations of less than $250.]

    b. A receipt from the charity showing the name of the donee, the date, and amount of the contribution. [This answer is incorrect. For donations of more than $250 this is not considered sufficient proof of donation.]

    c. A written acknowledgment from the charity with the amount donated noted, as well as whether or not the donor received goods or services in return. [This answer is correct. According to the IRS Regulations, donors must get a written acknowledgement from the charity when a donation is more than $250 that also indicates whether or not the donee organization provided any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization.]

14. In 2009, Roger is looking for someone to appraise a personal property contribution he believes is worth more than $5,000. Choose the appraiser that would be considered a qualified appraiser by the IRS. **(Page 121)**

    a. Alex: Received an appraisal designation from the Appraisal Institute and has performed appraisals for one year. [This answer is incorrect. The IRS requires a qualified appraiser to have at least two years of experience valuing the type of property in question. Alex does not have enough experience.]

    b. Minnie: Regularly performs appraisals for compensation but does not have formal education in appraising property. [This answer is incorrect. The IRS requires a qualified appraiser to have either completed professional or college-level coursework or earned a recognized appraisal designation. Minnie has done neither.]

    c. Jose: Has worked for a firm performing 100 appraisals a month for three years, and he received his appraisal designation from the American Society of Appraisers. [This answer is correct. Jose meets the IRS requirements to be considered a qualified appraiser because not only does he have the necessary experience, but he also earned his appraisal designation from a recognized organization.]

    d. Brian: Received his appraisal designation in 2005; in 2009 he was prohibited from practicing before the IRS for the 2009 tax year. [This answer is incorrect. Brian's prohibition from practicing before the IRS eliminates Brian as a qualified appraiser.]

15. Brent is donating a qualified vehicle to the United Way for their yearly auction. The United Way intends to transfer the vehicle to the highest bidder. Guests of this auction consist of CEOs from various multimillion dollar companies. What amount will Brent be able to deduct for his charitable contribution deduction? **(Page 126)**

    a. His basis in the vehicle. [This answer is incorrect. The donor's basis is not considered when determining the amount allowed for his contribution deduction.]

    b. The original cost of the vehicle. [This answer is incorrect. The original cost is not relevant when assessing charitable contributions of qualified vehicles.]

    c. The FMV at the time of donation. [This answer is incorrect. From the information given, the United Way does not plan on auctioning the vehicle to a needy individual. FMV is not considered as the deduction amount.]

    d. The gross proceeds from the sale of the vehicle. [This answer is correct. According to the Code, if a charity sells a qualified vehicle donated by the taxpayer without any significant intervening use of or material improvement to the vehicle the taxpayer's charitable deduction is limited to the gross proceeds from the sale.]

16. In which of the following scenarios is the taxpayer able to deduct a loss and a charitable deduction? **(Page 126)**

    a. Alan donates $100,000 every year to the local hospital. [This answer is incorrect. This scenario represents a cash donation that would be eligible for a charitable deduction limited to 50% of his AGI, but a loss does not occur.]

    b. Vince owns property that he purchased five years ago for $20,000. Today, the property is worth $30,000. He decides to donate the property to his church. [This answer is incorrect. Vince's donation would result in a charitable deduction, but because his property increased in value a loss would not be recognized.]

    c. Carla owns a piece of real estate investment that she purchased 15 years ago for $60,000. Today, the property has a FMV of $57,000. At the end of this year she donated the investment to her local high school. [This answer is incorrect. While the property donated decreased in value, it was not sold. The charitable deduction is valued at the property's FMV at the time contributed.]

d. George bought a piece of property ten years ago for $20,000. Today, the property is worth $5,000. He sold the property for $5,000 then donated the proceeds to the United Way. [This answer is correct. Because George sold his property at a decreased value, he sustained a deductible loss of $15,000. Donating the $5,000 cash proceeds resulted in a charitable contribution of $5,000. Information about this type of donation can be found in the IRS Revenue Rules.]

Use the following information for Questions 17 & 18:

Mary is donating an unimproved house to her church. The property was a capital asset she had held for a little over two years. The following data relates to the donation.

Mary's adjusted basis	$26,000
Property's FMV	$47,000
Outstanding mortgage	$12,000
Original cost	$45,000

17. What amount can Mary claim as her charitable contribution deduction amount? **(Page 126)**

a. $35,000. [This answer is correct. Under the Code, Mary's charitable contribution is equal to the FMV of the property minus the amount realized. $47,000 − $12,000 = $35,000.]

b. $26,000. [This answer is incorrect. When donating debt-encumbered property the donor's adjusted basis in the property is not used in computing his or her charitable contribution deduction amount.]

c. $47,000. [This answer is incorrect. This amount represents the FMV of the property without taking into account any ordinary income and short-term capital gain that the taxpayer would have recognized had the property been sold rather than gifted.]

18. When applying bargain sale rules, what amount is considered Mary's allocable basis? **(Page 126)**

a. $0. [This answer is incorrect. Donating debt-encumbered property generally results in both recognized gain and a charitable gift deduction for the taxpayer.]

b. $6,630. [This answer is correct. Under the Code, Mary's allocable basis is equal to her adjusted basis multiplied by the ratio of amount realized over FMV of the property. $26,000 × ($12,000/$47,000) = $6,630.]

c. $12,000. [This answer is incorrect. The amount realized does not represent taxpayer's allocable basis when computing the long-term capital gain of a bargain sale.]

19. Mike purchased four $200 tickets to a hockey game for the purpose of raising funds for the Muscular Dystrophy Association (MDA). The actual value of each ticket is $40. Mike returned one ticket to the MDA. He and a friend used two tickets to attend the hockey game. The third ticket remained unused because another friend cancelled at the last minute. What is Mike's charitable contribution to the MDA? **(Page 133)**

a. $640. [This answer is incorrect. This amount reduces each ticket's purchase price by the actual value. ($200 − $40) × 4 = $640.]

b. $680. [This answer is correct. Because Mike returned one ticket to the MDA he is eligible to deduct the full purchase price for this ticket under an IRS Revenue Rule. For the other three tickets, he must take into account the actual value. $200 + {3 × ($200 − $40)} = $680.]

c. $720. [This answer is incorrect. The fact that one of Mike's friends was unable to attend the hockey game at the last minute should not be factored into the calculation. Mike cannot deduct the full $200 for that ticket merely because it was not used.]

d. $800. [This answer is incorrect. Mike is only allowed the full cost of purchase on one ticket. The deduction for the other three tickets must be reduced.]

20. All of the following result in a charitable contribution for 2009, **except: (Page 135)**

    a. A taxpayer delivers a check for $2,500 to a charity on December 27, 2009. [This answer is incorrect. Payment made by check is considered made on the date of delivery.]

    b. A taxpayer mails an endorsed stock certificate to a charitable donee on December 31, 2009. [This answer is incorrect. If a taxpayer mails a properly endorsed stock certificate to a charitable donee, the donation is considered made on the date of on the date of mailing.]

    c. A taxpayer charges a contribution to a credit card on December 25, 2009, and pays the credit card bill on January 6, 2010. [This answer is incorrect. Contributions charged to a credit card are deductible in the year the charge is made, even though not paid until the following year.]

    d. A taxpayer directs his or her broker to transfer stock to a charity on December 20, 2009; the transfer was completed on the broker's books January 8, 2010. [This answer is correct. According to the IRS regulations, donor delivers the stock certificate to his broker (as the *donor's* agent) the contribution is completed when the stock is transferred on the books of the broker.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TDBTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

11. Select the list that contains only "50% charities."

    a. Churches, private operating foundations, and hospitals.

    b. Nonprofit cemeteries, schools, and domestic fraternal societies.

    c. Veteran's organizations, churches, and nonprofit cemeteries.

    d. Domestic fraternal societies, hospitals, and schools.

12. John donated $12,000 cash to the Heavenly Haven Church. John also donated $6,000 cash to a local hospital and $5,000 to the Mason's fraternal society. John's AGI for 2009 is $40,000. How much can John deduct in 2009 and what amount will be carried over to 2010?

    a. $23,000; $0.

    b. $20,000; 30% carryover $3,000.

    c. $20,000; 50% carryover $3,000.

    d. $12,000; 50% carryover $6,000 and 30% carryover $5,000.

13. Sarah donated property valued at less than $250 to her church. She was unable to obtain a receipt. Which of the following information would ***not*** be needed when creating a written record for the donation?

    a. A detailed description of the property.

    b. The terms or conditions attached to the gift.

    c. The organization's name and the date and place of the contribution.

    d. The original cost of the property as well as the original receipt from the purchase of the property.

14. Marge contributes to the United Way through payroll deduction. Select the answer choice that contains both documents required to substantiate her contributions.

    a. A pay stub and pledge card.

    b. A pay stub and Form W-2.

    c. A written receipt from the United Way indicating the amount contributed and a Form W-2.

    d. A pledge card and document from United Way indicating they did not provide goods or services for the contributions.

15. Which of the following would result in a contribution deduction based on the property's fair market value (FMV)?

    a. Short-term capital gain property.

    b. Appreciated property created by the donor.

    c. Tangible personal property considered a related use item by the donee.

    d. Tangible personal property considered a unrelated use item by the donee.

16. A charity is treated as making a material improvement to a qualified vehicle if it makes which of the following improvements?

    a. Paints the exterior.

    b. Replaces the transmission.

    c. Installs a theft deterrent device.

    d. Buffs out minor scratches and dents.

17. Amy donated her 2004 vehicle to her church. Amy's current basis in the vehicle is $2,000 and the FMV is $1,200. The church has decided that they are going to raffle off the vehicle as is. Gross proceeds from the raffle were $300. What amount will Amy record as her charitable deduction?

    a. $300.

    b. $500.

    c. $1,200.

    d. $2,000.

18. In the current year, Morris sells unimproved real property to his church. The following data was collected:

Morris's adjusted basis and sales price	$ 3,000
Property's FMV	$ 60,000
Original cost	$ 45,000

    Morris will recognize what amount of long-term capital gain as a result of the sale?

    a. $0.

    b. $2,800.

    c. $2,850.

    d. $3,000.

19. When a donor contributes to colleges and universities and receives the right to purchase tickets for athletic events at the institution's stadium, the donor is only allowed to deduct what percent of the contribution?

    a. 20%.

    b. 30%.

    c. 50%

    d. 80%.

20. Which of the following out-of-pocket expenses are ***not*** deductible as charitable contributions?

    a. Child care.

    b. Transportation.

    c. Office supplies.

    d. Long distance charges.

Lesson 4: Deductible Taxes

INTRODUCTION

Certain income, real estate, personal property, state and local sales, and (for 2009 only) qualified motor vehicle 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 (or, in some cases, as additions to the standard deduction). 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, was extended through 2009 by the Tax Extenders and AMT Relief Act of 2008.

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.

A tax generally can be deducted only by the taxpayer on whom the tax is imposed (i.e., the individual who has legal title for property taxes). Therefore, special rules apply for apportioning real property taxes between buyers and sellers of property.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:

- Differentiate between deductible and nondeductible taxes.

How to Distinguish between Deductible and Nondeductible Taxes

Certain income, real estate, personal property, state and local sales, and qualified motor vehicle sales 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 on Schedule A of Form 1040 as itemized deductions.

Income Taxes

State and local income taxes generally are deductible for the tax year within which paid, withheld, or credited to the current year taxes on the state income tax return. This is true even if the payment is for taxes owed in previous years and it is paid by the employer and treated as wages. Foreign income taxes can be deducted or a foreign tax credit can be claimed. However, neither the deduction nor the credit can be claimed if the income is exempt from U.S. tax under the foreign earned income or housing exclusion. Refunds of income taxes paid in prior years do not reduce the current year deduction. Such amounts are included in taxable income to the extent a tax benefit was received in the earlier year.

Real Estate Taxes

State, local, and foreign real estate taxes levied for the general public welfare are deductible if the tax is (1) based on the assessed value of the property, and (2) charged uniformly against all property in the taxing authority's jurisdiction. To be deductible, taxes must be imposed by a governmental body. Thus, payments to a development company for maintenance of streets, parks, fire and police protection, and garbage collection are not deductible. Likewise, payments to homeowner associations are not deductible.

Taxes charged for local benefits or improvements that tend to increase the taxpayer's property value are not deductible. A tax is considered assessed for local benefits when property assessed with the tax is limited to property benefited. It is not necessary for the property's value to actually increase. Thus, local or special assessments charged only against benefited property are not deductible if the benefit generally tends to increase property values. However, assessments to meet maintenance or repair costs or interest charges for the local benefit are deductible (if the taxpayer can substantiate them) as taxes on Schedule A because such expenditures do not tend to increase property values.

Example 4A-1 Deducting municipal utility district taxes.

During 2009, 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?

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 2009 Schedule A.

Personal Property Taxes

State and local personal property taxes are deductible if they are (1) based on the value of the property; (2) charged on a yearly basis; and (3) imposed in respect of personal property. A tax can be a personal property tax even if it is for the exercise of a privilege (e.g., a motor vehicle registration fee), if it meets these qualifications.

Example 4A-2 Registration fee qualifying as a personal property tax.

George pays an annual motor vehicle registration fee of 1% of value plus $1 per hundredweight. His fee for 2009 was $134, based on the value of $10,000 and weight of 3,400 pounds.

George can deduct $100 (1% × $10,000) as a personal property tax, since this portion of the tax is based on value. The tax is deducted on Schedule A as an itemized deduction. The remaining $34 ($1 × 34) is not deductible because it is based on weight instead of value.

Sales Taxes

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.

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 IRS Pub. 600 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/app/stdcl**) 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, for 2009, 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 motor vehicles is higher than the general tax rate, the deduction is limited to the general tax rate amount.

Example 4A-3 Applying varying sales tax rates.

Tim resides in a state that assesses an 8% sales tax on the retail price of most goods (i.e., 8% is the general tax rate). The rate on food, clothing, and medical supplies is 4%, the rate on motor vehicles is 6%, and the rate on electric-powered home appliances is 7%.

The 4% tax on food, clothing, and medical supplies is deductible as a general sales tax, even though the rate is lower than the 8% general tax rate. The 6% tax on motor vehicles is also deductible. The 7% tax on home appliances, however, is not deductible because the items are not food, clothing, medical supplies, or motor vehicles, and the rate on the items is different from the 8% general tax rate.

Variation: Assume that the tax rate on motor vehicles is 10%, and Tim buys a car for $30,000, paying $3,000 in tax. Because the tax rate on the motor vehicle is more than the 8% general tax rate, Tim can deduct only the $2,400 tax he would have paid if the general tax rate (8%) was applied.

Example 4A-4 State income tax refund limited.

For 2008, Tim deducted $11,000 of state income tax in lieu of a $10,000 sales tax deduction. In 2009, he received a $2,500 state income tax refund. Tim must report $1,000 of the state income tax refund as federal income in 2009 (the excess of the actual state income tax deduction over the available $10,000 sales tax deduction).

Qualified Motor Vehicle Sales Taxes

The American Recovery and Reinvestment Act of 2009 allows taxpayers to deduct state or local sales or excise taxes paid on a qualified motor vehicle up to the first $49,500 of cost. The taxpayer may elect to take the deduction either as an additional component of the standard deduction or as an itemized deduction (on Schedule A), but not both.

Requirements. A qualified motor vehicle includes a new car, light truck, motor home, or motorcycle purchased after February 16, 2009, and before January 1, 2010. The deduction is phased out for taxpayers with modified AGI between $125,000–$135,000 (single or MFS) or $250,000–$260,000 (joint). The $49,500 limit may be applied to more than one vehicle.

No Sales Tax States. The deduction is available even for taxpayers who reside in states with no sales tax. Such taxpayers may deduct other fees or taxes imposed by the state or local government that are assessed on the purchase of the vehicle if they are based on sales price or as a per-unit fee.

Business-use Vehicles. Normally, the sales tax paid on a business-use vehicle is capitalized (based on business-use percentage) and depreciated over the life of the vehicle. However, the new law removes the capitalization requirement for these taxes and permits taxpayers to deduct them on their 2009 returns.

AMT Implications. The decision about how and where to deduct qualified motor vehicle sales taxes may impact the taxpayer's AMT liability.

Other Taxes

Taxes other than the ones discussed previously may be deductible if they are incurred in the taxpayer's trade or business or for the production of income. Such taxes include the employer's portion of employee payroll (FICA) taxes, occupational taxes, and license fees. Employment taxes for household employees (e.g., for a maid, gardener, etc.) generally are personal in nature and not deductible. (However, employment taxes paid in connection with in-home nursing or long-term care may be deducted as a medical expense).

Reporting Deductible Taxes

Generally, taxes are deductible on Schedule A. However, taxes [other than state, local, or foreign income taxes] attributable to:

1. the taxpayer's trade or business (other than as an employee) are deductible on Schedule C;

2. the taxpayer's farming activity are deductible on Schedule F;

3. the trade or business of being an employee (e.g., auto expenses) are deductible as a Schedule A miscellaneous itemized deduction subject to the 2%-of-AGI floor;

4. property held for the production of rents or royalties are deductible on Schedule E; and

5. the estate tax on income in respect of a decedent is deductible as a Schedule A miscellaneous itemized deduction not subject to the 2%-of-AGI floor.

Electing to Capitalize Real or Personal Property Taxes

Taxpayers can elect (for certain property) to capitalize carrying charges that normally would be deductible. Carrying charges include taxes. This election is helpful when the taxpayer does not itemize or would otherwise receive little or no benefit from deductible taxes (e.g., because of AMT or an NOL carryforward).

Example 4A-5 Election to capitalize carrying charges.

Sherry owns a valuable tract of undeveloped real estate near a shopping mall. Property taxes are $20,000 per year. Sherry expects to sell the property in a few years. She currently has an NOL carryover, so deducting the property taxes provides her with no current tax savings. (The property taxes are not required to be capitalized under IRC Sec. 263A, the UNICAP rules.)

Sherry can elect, pursuant to IRC Sec. 266, to capitalize the property taxes on the unimproved real property. By making this election, the taxes increase her basis in the land. Therefore, when Sherry sells the land, the gain on sale will be reduced by the capitalized taxes. This is more likely to provide her with a tax benefit, particularly if her NOL has been fully utilized or has expired prior to the year of sale. The election to capitalize the property taxes would also be appropriate if Sherry was subject to the AMT.

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.

Example 4B-1 Deducting year-end state income tax estimated payments.

Cary's 2009 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, 2009; June 15, 2009; October 15, 2009; and January 15, 2010. Cary made all the payments when due, except the last one, which was made on December 31, 2009. He made no other state income tax payments in 2009. What is Cary's 2009 deduction for state income taxes?

Cary can deduct $4,000 of state income taxes on his 2009 Schedule A. The fourth quarter payment is deductible in 2009 because it was paid in 2009, and Cary had a reasonable basis for making the payment.

How to Apportion Real Property Taxes between Buyer and Seller

When real property is sold, the buyer and seller must apportion the real estate taxes for the year of sale. The agreement between the buyer and seller concerning who pays the taxes does not necessarily determine who gets to deduct the taxes because a taxpayer cannot deduct real property taxes actually imposed on another taxpayer. Generally, regardless of the taxpayer's overall method of accounting, the date of sale and the real property tax year

(based on applicable state law) determine each party's share of the taxes. Essentially, property taxes must be apportioned between the buyer and seller based on the number of days each held the property during the real property tax year.

Real estate taxes are not apportioned if delinquent taxes are owed at the time of sale. If the buyer pays the delinquent taxes, they are added to his or her basis in the property and are indirectly deductible by the seller (since there is a corresponding decrease in the sales price of the property) if the sale is a taxable sale (i.e., not a residence qualifying for gain exclusion).

Property taxes are paid by either the seller or the buyer depending on the date the taxes are payable under state law. Then, at closing, the nonpaying party typically reimburses the paying party for his or her share of the taxes.

Example 4C-1 Buyer reimburses the seller for property taxes paid before closing.

Jeff and Goldie Bridges purchased their home on September 1, 2009, from Ron and Red Howard. The property tax year in their locality is the calendar year, and the tax is payable on August 1. The Howards paid 2009 taxes of $10,000 on August 1, 2009. (This payment was made through their escrow account and was reflected on their year-end statement from the mortgage company.) The Bridges' settlement costs paid at closing included $3,342 (122 ÷ 365 × $10,000) representing their share of the 2009 taxes.

The Bridges and Howards can each deduct their share of the 2009 taxes in 2009. Although their year-end mortgage statement will show $10,000 of taxes paid, the Howards must reduce this amount by the $3,342 apportioned to the Bridges and shown on the closing statement for the sale of the house. This results in a Schedule A deduction for the Howards of $6,658 ($10,000 − $3,342).

If the property taxes are paid by the buyer after the date of the sale, the seller is treated as though he paid his share of the taxes on the date of the sale. The buyer can deduct his share of the taxes as of the date the taxes are actually paid.

Example 4C-2 Seller reimburses the buyer for property taxes paid after closing.

Assume the same facts as in Example 4C-1 except the 2009 taxes are payable under local law on January 1, 2010; the Bridges paid the $10,000 on that date; and the Howards' settlement costs included $6,658 as their share of the 2009 taxes. Further assume that the Howards paid $9,000 of 2008 property taxes (through their escrow account) on January 1, 2009.

The Bridges can still deduct their $3,342 share of the 2009 taxes, but not until 2010, the year the taxes were actually paid. The Howards are treated as though they paid their share of the 2009 taxes on the date of the sale. They can thus deduct their $6,658 share of the 2009 taxes in 2009. They can also deduct the entire amount of the 2008 taxes paid in 2009 because they owned the house for all of 2008. Thus, the Howards' 2009 property tax deduction is $15,658 ($9,000 + $6,658).

SELF-STUDY QUIZ

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

21. Tax paid on which of the following property is deductible as an itemized deduction on Schedule A?

    a. Business property.

    b. Rental property.

    c. Farm property.

    d. Personal use property.

22. When property is sold, real property taxes for the year of sale are deductible by:

    a. The seller.

    b. The buyer.

    c. Apportioning the taxes between the buyer and the seller.

    d. The person paying the taxing authority.

23. Which of the following taxes is deductible as an itemized deduction?

    a. Federal income tax.

    b. State income tax.

    c. Personal property tax based on the weight of a vehicle.

    d. Employer payroll tax.

24. Grayson has receipts for sales taxes paid in 2009 of $1,300. In addition, he purchased an automobile and paid $1,600 in sales tax. The IRS tables for sales tax applicable to Grayson yield a deduction of $2,000. What is Grayson's maximum deduction for sales tax assuming a rate of 8% on all purchases?

    a. $1,300.

    b. $2,000.

    c. $2,900.

    d. $3,600.

25. Bill resides in a state where the following sales tax rates apply:

General sales tax	7%
Clothing sales tax	6%
Vehicle sales tax	5%
Home insulation sales tax	4%

Bill may ***not*** deduct sales tax for which item?

a. General.

b. Clothing.

c. Vehicle.

d. Home insulation.

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.)**

21. Tax paid on which of the following property is deductible as an itemized deduction on Schedule A? **(Page 151)**

    a. Business property. [This answer is incorrect. Business property taxes are deductible on Schedule C.]

    b. Rental property. [This answer is incorrect. Rental property taxes are deductible on Schedule E.]

    c. Farm property. [This answer is incorrect. Farm property taxes are deductible on Schedule F.]

    d. Personal use property. [This answer is correct. Under the IRS Regulations, personal use property taxes are an itemized deduction on Schedule A.]

22. When property is sold, real property taxes for the year of sale are deductible by: **(Page 154)**

    a. The seller. [This answer is incorrect. Sellers deduct taxes for only the part of the year they owned the property.]

    b. The buyer. [This answer is incorrect. Buyers deduct taxes applicable to the period beginning with the date of the purchase.]

    c. Apportioning the taxes between the buyer and the seller. [This answer is correct. According to the Code, property taxes must be apportioned between the buyer and the seller based on the number of days each held the property during the real property tax year.]

    d. The person paying the taxing authority. [This answer is incorrect. Taxes are deducted based upon the time the buyer and seller each owned the property.]

23. Which of the following taxes is deductible as an itemized deduction? **(Page 151)**

    a. Federal income tax. [This answer is incorrect. Federal income tax paid is deducted from the tax due.]

    b. State income tax. [This answer is correct. According to the Internal Revenue Code, state income taxes are deductible as an itemized deduction in the tax year within which paid, withheld, or credited to the current year taxes on the state income tax return.]

    c. Personal property tax based on the weight of a vehicle. [This answer is incorrect. Personal property tax based on the weight of a vehicle is not deductible. Personal property tax based on the value of a vehicle, however, is deductible.]

    d. Employer payroll tax. [This answer is incorrect. Employer payroll taxes are deductible for adjusted gross income (AGI) as a business tax.]

24. Grayson has receipts for sales taxes paid in 2009 of $1,300. In addition, he purchased an automobile and paid $1,600 in sales tax. The IRS tables for sales tax applicable to Grayson yield a deduction of $2,000. What is Grayson's maximum deduction for sales tax assuming a rate of 8% on all purchases? **(Page 151)**

    a. $1,300. [This answer is incorrect. Taxpayers can deduct the larger of the amount paid or the amount calculated using IRS tables.]

    b. $2,000. [This answer is incorrect. Taxpayers who use the IRS tables can also add sales taxes paid for the motor vehicles.]

    c. $2,900. [This answer is incorrect. Taxpayers can deduct the larger of the sales tax paid or the IRS tables and in addition, sales tax on vehicles is deductible.]

    d. $3,600. [This answer is correct. According to IRS Regulations, Grayson can deduct sales tax paid on the vehicle in addition to the larger of $1,300 or $2,000.]

25. Bill resides in a state where the following sales tax rates apply: **(Page 151)**

General sales tax	7%
Clothing sales tax	6%
Vehicle sales tax	5%
Home insulation sales tax	4%

    Bill may ***not*** deduct sales tax for which item?

    a. General. [This answer is incorrect. General sales tax paid is deductible. The term general sales tax means a tax imposed at one rate.]

    b. Clothing. [This answer is incorrect. Clothing sales tax paid is deductible even if it is at a rate lower than the general sales tax rate.]

    c. Vehicle. [This answer is incorrect. Vehicle sales tax paid is fully deductible since it is less than the general sales tax.]

    d. Home insulation. [This answer is correct. According to the Code, items other than general sales tax are not deductible, except for food, clothing, medical supplies, and motor vehicles.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (TDBTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. Paula estimated her 2009 state income taxes to be $2,800. The due dates for estimated payments were April 15, 2009; June 15, 2009; September 15, 2009; and January 15, 2010. Paula paid the first three payments on the due dates but paid the last payment on December 30, 2009. What is Paula's 2009 deduction for state income tax?

    a. $2,800.

    b. $2,100.

    c. $700.

    d. $0.

22. Sam sold his personal residence to Mike on July 1, 2009. Property tax of $1,200 for the year was paid by Mike on November 1, 2009. The approximate amount that Sam can deduct for property tax in 2009 is:

    a. $0

    b. $600.

    c. $1,200.

    d. $1,000.

23. Beck paid the following income taxes during 2009:

State of Iowa	$	1,000
City of Ames	$	300
Federal	$	3,700

    What amount may Beck deduct as an itemized deduction?

    a. $300.

    b. $1,000.

    c. $1,300.

    d. $5,000.

24. In 2009, Bella paid personal property tax of $600 on her personal motor vehicle. The tax was based 25% on the value and 75% on the weight of the vehicle. What amount may Bella deduct for personal property tax?

    a. $0.

    b. $150.

    c. $450.

    d. $600.

25. Which of the following statements is most accurate regarding the deduction for sales tax when a taxpayer resided in two different states during 2009?

    a. Taxpayers must use the rate for the state that yields the lesser amount.

    b. Taxpayers can elect to use the rate for either state.

    c. Taxpayers must prorate the amount based on the income earned in each state

    d. Taxpayers must prorate the amount based on the days of residency in each state.

Lesson 5: Other Itemized Deductions

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 limitations include the 2% of AGI limitation (applicable to most miscellaneous itemized deductions) and the 3% of AGI/80% of itemized deduction phase-out (reduced by $^2/_3$ for 2009) for higher incomes. For 2009, taxpayers with AGI exceeding $166,800 ($83,400 for married filing separately) are subject to this itemized deduction phase-out rule. 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 that are not subject to the 2% of AGI limitation are also 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.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:

- Determine the deduction for personal casualty losses and gambling losses.
- Identify employee job-related expenses that qualify as miscellaneous itemized deductions or other itemized deductions.

Personal Casualty Losses

Determining the Nature and Amount of a Casualty Loss

IRC Sec. 165(c)(3) allows a deduction for losses resulting from a casualty or theft of personal-use property. A casualty is the damage, destruction, or loss of property resulting from sudden, unexpected, or unusual identifiable events, such as car accidents, storms, and floods. Thus, a loss from termites, drought, or disease generally is not a deductible casualty loss. However, sudden damage to property resulting from an equipment failure that is due to gradual decline can be a casualty. For example, damage to property (other than the water heater) caused by flooding after the taxpayer's hot water heater burst was a casualty even though the water heater's failure was due to rust and corrosion that occurred over time. See also *Cooper*, where damage due to flooding after a hose to the washing machine wore out was a casualty.

The damage must be permanent in nature and not merely a temporary decline in value. A deductible theft loss is the result of illegally taking property with criminal intent. Therefore, mislaid or lost property will not constitute a theft loss. Also, a decline in a stock's value due to illegal misconduct by corporate officers is not a theft loss.

The amount of the loss generally is the lesser of the adjusted basis of the property or the decrease in fair market value (FMV) due to the casualty or theft. Adjusted basis is determined when the casualty occurs. It does not include amounts spent to replace or repair the property.

The decrease in FMV is often a point of contention between the taxpayer and the IRS. Often, the cost of cleaning up or making repairs to restore property to its original condition can be used as a measure of the decrease in the FMV

of the property. However, to use the cost-of-repairs method to substantiate the amount of the loss, the repair expenditures must be made; estimates cannot be used. In addition, objective evidence (e.g., the "Blue Book" commonly used to value cars) may help establish FMV. If the loss is significant, the services of a competent appraiser should be obtained. For disaster losses in presidentially declared disasters [as defined in IRC Sec. 1033(h)(3)], the IRS is authorized to issue guidance (but has not yet done so) allowing appraisals used to obtain federal government aid to establish the amount of the casualty loss.

Effect of Insurance Proceeds and Certain Disaster Relief Payments

Once the amount of the casualty loss is determined, it must be reduced by expected insurance or other reimbursements. If personal-use property is covered by insurance but no claim is filed, no deduction is allowed for the portion of the loss that would otherwise be covered by insurance. A claim does not have to be filed for business-use property loss.

If an insurance reimbursement is expected but has not been received when the return is filed, the taxpayer must consider the expected reimbursement in determining the amount of loss. 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—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. [Thus, it is subject to additional $100 ($500 for 2009) and 10% of AGI reductions—see "Limitations on Personal Casualty Loss Deductions" later in this lesson.]

If the taxpayer later receives a larger reimbursement than expected, the additional amount is included in income in the year it is received to the extent a tax benefit was obtained from the prior-year deduction. If uncertainty exists about the amount of the reimbursement, that part of the loss should not be deducted until it is reasonably certain no reimbursement will be received.

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.

Example 5A-1 Insurance reimbursements for living expenses.

As a result of an earthquake, Alvin had to vacate his apartment for a month. The monthly rent for the apartment is $950, which was not charged for the month it was being repaired. During that time, Alvin stayed in a motel at a cost of $1,400 and received $1,300 from his insurance company.

Alvin is deemed to have been reimbursed for increased expenses of $450 ($1,400 for the motel stay less normal rent of $950), and that amount is not taxable. The $850 balance of the insurance payment ($1,300 less the $450 increased living expenses) is taxable income that Alvin reports on line 21 (Other income) of his Form 1040 (IRS Pub. 17).

Food, medical supplies, and other forms of general disaster-related assistance (other than amounts to compensate for damaged property) received by a taxpayer are not considered in calculating the amount of a casualty loss, nor is such assistance considered taxable income.

Any amount received by an individual as a *qualified disaster relief payment* is excluded from gross income. A qualified disaster relief payment is any amount paid to or for the benefit of an individual: (a) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster (defined later); (b) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for the repair, rehabilitation, or replacement is attributable to a qualified disaster; (c) by a person engaged in the furnishing or sale of transportation as a common carrier by reason of death or personal physical injuries incurred as a result of a qualified disaster; or (d) if a federal, state, or local government or agency pays such amount, in connection with a qualified disaster in order to promote the general welfare. However, this exclusion does not apply to payments made by a governmental agency with respect to income replacement, such as lost wages, unemployment

compensation insurance, or business income replacement payments. Nor does the exclusion apply to amounts received from insurance for expenses.

A qualified disaster includes a disaster resulting from a terrorist or military action, a presidentially declared disaster, a disaster resulting from an accident involving a common carrier, or from any other event determined by the IRS to be of a catastrophic nature. Regarding payments made by a federal, state, or local government, a qualified disaster also includes a disaster designated by the governmental authorities as warranting assistance. A qualified disaster relief payment is not subject to self-employment or FICA tax. See Rev. Rul. 2003-12 for examples of excludible payments under IRC Sec. 139. Also, payments from a charitable organization whose purpose is to provide assistance to individuals affected by disasters may not fall under IRC Sec. 139, but are still excludible under IRC Sec. 102 (pertaining to the receipt of gifts).

Qualified Disaster Mitigation Payments. A *qualified disaster mitigation payment* is any amount that is paid pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act, (as in effect on April 15, 2005) or the National Flood Insurance Act (as in effect on April 15, 2005), to or for the benefit of the owner of any property for hazard mitigation (e.g., flood control) with respect to such property. Qualified disaster mitigation payments are not included in gross income. No increase in the basis or adjusted basis of any property shall result from any qualified disaster mitigation payment excluded with respect to such property.

Example 5A-2 Increase in basis not allowed for excluded payments.

Alex received $53,000 as a qualified disaster mitigation payment to elevate her home in an area that frequently floods. Alex spends the entire $53,000 on elevation improvements. Although the amount is excluded from income, Alex is unable to increase the basis in her home by the $53,000 amount. Any expenditure in excess of the $53,000 would result in an increase in basis.

Limitations on Personal Casualty Loss Deductions

For personal casualties, the loss (after considering insurance proceeds or other reimbursements) from each separate theft or casualty must first be reduced by $100 ($500 for tax years beginning in 2009 only). For example, if a client suffers one loss from a fire and another from a flood, the $100 ($500 for 2009) rule applies twice—to the loss from each casualty. After applying the $100 ($500 for 2009) rule, the taxpayer's personal casualty losses for the year can be deducted only to the extent the total exceeds 10% of AGI. The loss, however is limited to the adjusted basis of the asset as defined in IRC Sec 165.

Example 5A-3 Computing amount of deductible casualty loss.

Ray purchased a used car for $10,000 from an unrelated seller in September 2009. Because of his poor driving record, he could not obtain collision insurance. In October 2009, Ray totaled the car. He received $500 for parts and otherwise suffered a complete loss. His AGI for 2009 was $35,000.

Ray's deductible loss of $5,500 is computed on Form 4684 and deducted on Schedule A.

If Ray had insurance coverage on the car but decided not to file a claim (e.g., because his coverage would be terminated), he would have to reduce the casualty loss deduction by any insurance coverage he would have been entitled to had he filed a claim. Thus, in all likelihood, Ray's casualty loss would equal the amount of his deductible, which would then be subject to the 10% of AGI and $500 limits for 2009.

When to Report Personal Casualty and Disaster Losses

Generally, casualty losses are deductible in the year incurred (it does not matter when the property is replaced or repaired). If the casualty loss occurs in a presidentially declared federal disaster area and is attributable to a federally declared disaster (see **www.fema.gov** for designated areas), the taxpayer may elect to deduct the loss on the return for the immediately preceding year. If that return has been filed, it may be amended for a refund of taxes already paid. This decision is based on a number of factors, the two most important of which are the loss's maximum deduction based on AGI level and the taxpayer's cash flow situation (if the refund is needed immediately to offset the economic loss). Theft losses, on the other hand, are deductible in the year discovered. If insurance

proceeds or other reimbursements are anticipated, the loss is reported in the year the taxpayer can reasonably determine that no additional reimbursement is forthcoming.

Example 5A-4 Claiming a casualty loss when insurance reimbursements are less than expected.

Linda's boat was destroyed in a tornado in 2008. The loss was $6,000. She did not deduct any loss in 2008 because she expected full reimbursement from her insurance company. However, the claim was denied because, due to a technicality, her coverage was not in force. After threatening a lawsuit, Linda settled with the insurance company for $4,000 in 2009. The $2,000 loss ($6,000 − $4,000) should be claimed on Linda's 2009 return subject to the $500 (for 2009) and the 10% of AGI rules using 2009 AGI.

Variation: Assume the same facts except that Linda had no insurance. In this case, Linda would deduct her loss in 2008. However, if the loss occurred in a presidentially declared disaster area, Linda could deduct the loss in 2007 (the immediately preceding year) or 2008.

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. Likewise, expenses incurred by a new college graduate seeking first-time employment are not deductible because the work being sought is not considered to be in "the same trade or business" of the taxpayer. 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.

Temporary Employment or Temporary Unemployment While Searching. Expenses incurred while temporarily employed 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.

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.

Example 5B-1 Job search expenses while unemployed.

Tim was working as a mechanical engineer when he was laid off in January 2009. In October 2009, 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."

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 phaseout for certain itemized deductions. (See the Introduction to this lesson.)

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 counselling fees, postage, typing and printing, and advertising. 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.

Example 5B-2 Deductible job search expenses

Jack and Pat are father and son. Jack 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. Pat recently graduated high school and decided to enter the construction business in an entry-level position. Jack spends $3,000 on travel costs and resumes, but is unable to locate a foreman's position. Pat spends $500 on travel costs and locates an entry-level position. Jack's job search expenses are deductible, even though he was unable to locate a position, since the expenses are for finding work in the same trade or business. Pat'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.

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. 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 (55 cents per mile for 2009) can be used to compute automobile expenses.

Example 5B-3 Job search travel expenses.

After losing his job, in January 2009 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 $220 (400 miles $\times$ $0.55 per mile) in addition to the agency fee and resume expenses.

Employee Business Expenses

Employer Expense Reimbursement Arrangements

IRC Sec. 62(a)(2)(A) allows an above-the-line deduction (to the employee) for employee business expenses incurred under certain employer expense reimbursement arrangements. This deduction applies when employer reimbursements are erroneously reported as income to the employee, and the employer's expense reimbursement plan is either (1) an "accountable plan" or (2) a per diem or mileage reimbursement plan.

An accountable plan is an expense or reimbursement arrangement that meets two conditions:

1. The plan must require the proof of a business connection and substantiation of employee expenses to the employer.

2. The plan must require the employee to return any amounts received that exceed the expenses actually incurred.

Accountable Plans. The IRS has instructed employers who operate accountable plans *not* to report expense reimbursements as income to employees. Conversely, employers who operate nonaccountable plans must report reimbursements as income to employees (subject to FICA and income tax withholding). However, as discussed at "Special Rules for Travel and Mileage Reimbursement Plans" in this lesson, special rules apply to per diem and mileage reimbursement plans.

Of particular interest to the IRS are employee tool and equipment reimbursement plans provided mainly for the auto industry and service and repair technicians. The plans are generally marketed as a tax favored accountable plan; however, the concern is that the substantiation and return of excess requirements are not being met. According to a Coordinated Issue Paper (CIP) on the Motor Vehicle Industry—Industry Employee Tool and Equipment Plans issued in July 2008, tool and equipment plans typically do not meet the accountable plan requirements of Reg. 1.62-2 because the plans generally fail to require substantiation of each element of an expenditure or use, including its business nature and proper reimbursable amount. Rev. Rul. 2005-52 provides that although reasonable expectations for expenses can be used to establish that a plan meets the business connection requirement, satisfaction of the substantiation and return of excess requirements must be based on actual expenses.

In January 2008, the IRS announced the establishment of a cross divisional team to address significant concerns on patterns of abuse of the accountable plan rules. Additionally, promoter investigations have been initiated and employer examinations identified. Plans that are found not to meet the accountable plan rules will be subject to employment tax and potential penalties. Taxpayers considering implementing a tool reimbursement plan should be cautious of the rules.

If the employer operates an accountable plan and does not report reimbursements as income, no action is required by the employee unless the employee's actual business expenses exceed employer reimbursements. In this case, total expenses and the employer's reimbursement (which is not included in income) generally are reported on Form 2106, and the excess (after application of the 50% meal and entertainment disallowance) is carried to Schedule A as a miscellaneous itemized deduction subject to the 2% of AGI limitation.

Example 5C-1 Deduction for business expenses in excess of employer reimbursement.

Lianna incurred $4,400 of meal and entertainment expenses in her job during 2009. Her expense account arrangement with her employer required adequate substantiation of all expenses and return of any excess reimbursements. Her company's reimbursement policy limited Lianna's reimbursement to $3,500 of her expenses. Lianna's 2009 Form W-2 does not include the $3,500 reimbursement in income.

Lianna reports her $4,400 of employee business expenses on line 5 of Form 2106 and her employer's $3,500 on line 7 of Form 2106. The $900 of excess expenses is subject to the 50% meal and entertainment disallowance. Therefore, $450 (50% of $900) of excess expense is carried from Form 2106 to Schedule A as a miscellaneous itemized deduction subject to the 2% of AGI limitation.

If the employer operates an accountable plan and incorrectly reports all or part of the expense reimbursements as income to the employee, both the employer and the employee will overpay FICA taxes. The employee should first request a corrected Form W-2 from the employer. If the employer does not comply, the employee is entitled to an above-the-line deduction equal to the income reported and can request a refund of the excess FICA taxes using Form 843 (Claim for Refund and Request for Abatement).

Special Rules for Travel and Mileage Reimbursement Plans. Employers that do not operate accountable plans must report expense reimbursements as wage income to employees. Obviously, a reimbursement arrangement that pays employees a fixed per diem amount (for travel) or a mileage-based amount (for business use of employee's vehicle) does not require (1) substantiation of actual amounts spent, or (2) the return of reimbursement in excess of the employee's actual expenses. However, the IRS has issued special rules that allow employers to treat per diem or mileage reimbursement plans as accountable plans.

If the employer's reimbursement rates do not exceed IRS rates, the employer should not report any income to an employee who substantiates time, place, business purpose, and mileage amounts (for mileage reimbursements). The amount of expenses actually incurred need not be substantiated, and the employee is not required to return reimbursements that exceed his actual expenses.

Example 5C-2 Employer's reimbursement does not exceed IRS rates.

In April 2009, John takes a two-day business trip to Chicago (a designated "higher cost locality"). The 2009 federal meals and lodging rate for Chicago is $256 per day, using the "high-cost locality" method in Rev. Proc. 2008-59. As required by his employer's accountable plan, he accounts for the time (dates), place, and business purpose of the trip. His employer reimburses him $256 a day ($512 total) for lodging and meal expenses. John's actual expenses in Chicago are less than $256 a day.

John's employer should not include any of the reimbursement on his Form W-2 (even though his expenses were less than his reimbursement), and John may not deduct the expenses on his return.

If the employer's reimbursement rates exceed the federal allowances, the employer should report only the excess as income to the employee. If, however, reimbursements did not exceed the federal allowances, yet income was reported, the employee should first request a corrected Form W-2 from his employer. If no corrected W-2 is provided, the employee is entitled to an above-the-line deduction equal to the lesser of:

1. the IRS per diem or mileage amount, or

2. the employer's per diem or mileage allowance.

If the employee's documented actual expenses exceed the employer's reimbursements (whether or not the reimbursements were reported as income to the employee), he can deduct the excess as a miscellaneous itemized deduction. If his expenses include amounts spent for travel, transportation, meals, or entertainment, they are initially reported on Form 2106 and then posted to Schedule A.

Failing to Seek Reimbursement. Reimbursable business expenses for which an employee does not seek reimbursement are not deductible by the employee because they are considered ordinary and necessary expenses of the employer, not the employee. Failing to seek reimbursement does not convert an employer's expenses into an employee expense. This is true even when the employer has placed a "travel freeze" in effect, if the employer provides a means to obtain an exception to the freeze with approval from an executive of the employer. This rule also applies regardless of whether the employee is aware that the employer will reimburse the expense.

Example 5C-3 Employee did not seek reimbursement for business expenses.

George, vice president of Spaceworks, Inc., is responsible for industrial relations. He must travel a great deal, usually in the company car available for his use. For meetings within the city limits, however, he prefers using his own smaller car for easier driving in heavy traffic. Even though Spaceworks has a reimbursement policy, George does not file a claim for reimbursement because the company is having cash flow problems.

George may not deduct the business use of his car because he had a right to reimbursement for the expenses. The expenses are the employer's, not the employee's. If George could show he would not have been reimbursed if he had filed a claim, the expenses would be deductible. Absent such proof, however, a taxpayer cannot convert a company's business expenses into personal deductible expenses simply by not seeking reimbursement.

As an alternative to claiming an employee business expense deduction for reimbursable business expenses, an individual corporate shareholder argued that the expenses were deductible pursuant to IRC Sec. 212 as expenses incurred in his capacity as an investor. However, the Tax Court ruled that a shareholder is not entitled to a deduction for the payment of corporate expenses.

The rule regarding nondeductibility of reimbursable business expenses is different for partners. Although a partner is generally not entitled to deduct partnership expenses on his individual tax return, a deduction is allowed for trade or business expenses if the partnership agreement or normal practice requires a partner to pay certain partnership expenses out of his own funds. However, the tax court has disallowed a partner's deduction for unreimbursed partnership expenses when the partner's only corroborating evidence was his own oral testimony.

Auto Allowances and Employer-provided Vehicles

If the employee receives a flat auto allowance, he must document the time, place, and business purpose for the auto usage and the amount of auto expenses incurred to provide the employer with substantiation. Also, the employee must return excess (unsubstantiated) amounts to the employer. If he fails to comply with either of these requirements, the employer must report the amounts not substantiated or returned as taxable wages on Form W-2 (subject to FICA and income tax withholding).

When an employer provides an employee with a company-owned vehicle, the employer often includes in the employee's income an amount for only the personal use portion of the vehicle usage, based on information provided by the employee. However, employers sometimes elect to report 100% of the value of employer-provided autos as income to employees—even though the employees have business use of the cars. Employees must then report any business use as a miscellaneous itemized deduction via Form 2106 with no above-the-line deduction allowed. The business-use deduction is determined by multiplying the value included in income by the percentage of business use.

Example 5C-4 Executive car allowance.

Sam negotiated a $750 per month car allowance arrangement with his employer. Sam incurs significant business mileage each year and tells his tax preparer he wants to deduct his actual car expenses above the line. (See discussion at beginning of this lesson.) Sam provides no substantiation to his employer so the entire auto allowance is included in his taxable wages.

Sam's arrangement with his employer is not an accountable plan because it does not require substantiation, nor does it require a return of excess amounts. Either of these deficiencies means all of Sam's car allowance is reported as wages while his employee business auto expenses are treated as miscellaneous itemized deductions subject to the 2% of AGI limitation.

When Is Form 2106 Required for Employee T&E and Auto Expenses?

Form 2106 is not needed if the employer requires adequate substantiation and reimburses the exact amount of substantiated expenses. In this situation, no income should be reported to the employee, and no deduction is taken by the employee.

Form 2106 is needed if the employee wants to take a deduction for auto and/or travel and entertainment expenses and any of the following situations apply: (1) the employer does not fully reimburse the employee, (2) the employer does not require adequate substantiation, or (3) the employer does not require the return of amounts in excess of substantiated expenses. Form 2106-EZ can be used in lieu of Form 2106 (1) if no employer reimbursements were received [or any reimbursement was included in income (i.e., box 1 of Form W-2)] and (2) if auto expenses are claimed, the standard mileage rate is used.

Example 5C-5 Reporting auto expenses on Form 2106.

Joe's employer advanced him 60.0 cents per mile for the 10,000 business miles Joe was expected to drive during 2009 (assume the miles are spread evenly throughout the year). His total advance was $500 per month (10,000 miles × $.60 ÷ 12). Joe substantiates to his employer that he did drive 10,000 business miles during 2009. However, Joe's records show that his actual car expenses for the year were $6,200.

On Joe's Form W-2, his employer includes $500 in box 1 as wages. The $500 is the amount of the total advance of $6,000 (10,000 miles × $.60) that exceeds $5,500 (10,000 total miles × the applicable standard mileage rates for 2009—$.55 per mile for 2009). The $5,500 is shown with a code L in box 12 of Joe's 2009 Form W-2.

To claim his excess expenses, Joe completes Form 2106 and reports his total expenses of $6,200 and his reimbursement of $5,500 shown in box 12 of his 2009 Form W-2. Joe will claim $700 ($6,200 − $5,500) as an itemized deduction.

Work-related Educational Expenses

General Rules

Expenses for work-related education may be deductible for certain employees, subject to the 2% of AGI limitation. To be deductible, expenses must be incurred for qualifying education, defined as education that:

1. is required by an employer or the law to keep a present salary, status, or job; or

2. maintains or improves skills required for present work.

Qualified educational expenses include tuition, books, supplies, lab fees, and similar items. Also, some transportation expenses are deductible, such as the cost of going directly from work to school and, for temporary or short-term classes, the cost of the entire round trip. Temporary, for this purpose, generally is considered to be a matter of days or weeks. Other deductible educational expenses include correspondence courses, tutoring, formal training, and word-processing expenses for papers.

Nonqualified educational expenses include the cost of education needed to meet the minimum requirements for a job or education that is part of a program to qualify for a new trade or business.

Travel Expenses. Deducting travel costs as educational expenses requires that the travel be a "necessary adjunct to engaging in an activity that gives rise to a business deduction relating to education". The travel expense must be necessary to allow the taxpayer to derive the educational benefit, and the travel itself must not be the education. IRC Sec. 274(m)(2) prevents a deduction for travel costs where the travel itself constitutes a form of education (e.g., where a French teacher travels to France to maintain general familiarity with the French language and culture). However, a San Francisco high school English teacher was allowed to deduct travel expenses for trips to Greece and Southeast Asia for focused academic courses sponsored by the University of California, Berkeley Extension Program. Her duties required her to develop curriculum and promote both intellectual growth and cultural and linguistic sensitivity for students that were mostly immigrants or whose parents were immigrants. The courses allowed her to significantly enhance her curriculum and to better understand her students' responses in class and to work more effectively with them. The Tax Court ruled the courses went beyond mere personal travel. They were focused, followed structured syllabi, and required significant completion of assignments. Therefore, the travel costs themselves were not deemed to be in the form of travel, but necessary as a part of otherwise deductible educational expenses.

Active Trade or Business or Current Employment Is Required

A taxpayer must be currently employed or otherwise engaged in a trade, business, or profession to deduct educational expenses as work-related expenses. However, the education expenses may provide some tax benefit as expenses related to the American Opportunity or Lifetime Learning credit available under IRC Sec. 25A(f)(1) or

the tuition and fees deduction under IRC Sec. 222. However, a taxpayer who temporarily leaves his job to pursue full-time education (and then returns to his job) continues to qualify for the deduction. The IRS considers a suspension period of one year or less to be temporary; the Tax Court is generally more liberal. In one situation, the court ruled that a school principal who quit his job to enroll in a three-year Ph.D program (full time) had only temporarily ceased employment, and thus his educational expenses were deductible.

Example 5D-1 Education required to maintain job.

Chad, an English teacher, is required by state law to take a certain number of college hours (equal to one class) each year to keep his teaching job. Therefore, he takes an English composition class in the spring semester. Chad can deduct the cost of tuition, books, and other related college fees associated with that course because the education is necessary for him to retain his teaching position. Alternately, Chad may be able to claim the Lifetime Learning credit or the tuition and fees deduction for the education expenses.

The cost of attending a convention, seminar, or similar meeting related to investing or financial planning is not deductible for a taxpayer not in the trade or business of investments. An unemployed engineer that spent an average of six and a half hours a day reviewing and executing stock trades was disallowed a deduction for the expense he incurred travelling to and attending a course to improve his day trading abilities. The taxpayer argued the cost should be deductible under Section 212(1) as an ordinary and necessary business expense because the seminar would allow him to become a better trader. However, at trial, the taxpayer conceded that he was not in the business of day trading, and the Tax Court looked to the specifics of IRC Sec. 274(h)(7) to disallow any deduction.

Educational Expenses Not Deductible

Qualification 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. 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. 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. 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. 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. (Such expenses, however, may be eligible for either the American Opportunity or Lifetime Learning education credits or the tuition deduction.)

Example 5D-2 Education leading to an advanced degree.

Assume the same facts as in Example 5D-1 except Chad 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. Here, Chad is not required by either the law or his employer to take more than one course. Nevertheless, his educational expenses are still deductible as work-related expenses because they meet the requirement of maintaining or improving his skills for his job and because 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. Thus, a change of duties in any of the following ways is *not* considered a change to a new business:

1. Elementary school teacher to secondary school teacher.

2. Teacher of one subject, such as mathematics, to teacher of another subject, such as science.

3. Classroom teacher to guidance counselor.

4. Classroom teacher to principal.

In a similar situation, the IRS ruled that a practicing attorney with four years of experience who resigned to pursue a masters degree in tax law could deduct his educational expenses. Important factors cited in the decision were that the attorney would suspend his trade or business of practicing law for less than a year, the courses were supplemental to the minimum educational requirements of the legal profession, and the courses improved on skills required in the practice of law, rather than qualifying him for a new trade or business.

More recently, the Tax Court ruled that a taxpayer working as a mental health practitioner with a master's degree in clinical psychology was unable to deduct costs incurred to obtain a doctorate of psychology degree because the expense qualified her for a new business or trade. The Court reasoned that the doctorate degree satisfied statutory requirements allowing her to become a licensed psychologist and qualified her to perform duties that were significantly different from the duties she performed before obtaining the doctoral degree.

Minimum Education Requirements. To be deductible by the taxpayer, the expense must not be for a minimum education requirement for the taxpayer's trade or business. To determine the minimum qualifications of a position, it is generally necessary to look to the employer or trade standards and applicable laws. The fact that a taxpayer is already active in an employment position does not mean that the taxpayer has met the minimum educational standards of that profession. A taxpayer employed as a marketing executive in the beverage industry was denied a deduction for the expense she incurred to obtain her MBA. The Tax Court found that because her undergraduate degree was in engineering, the MBA allowed her to meet only the minimum education requirements of her profession).

However, the obtaining of an advanced degree does not necessarily disallow the deduction of educational expenses. In *Allemeier*, the Tax Court ruled that the taxpayer's MBA related expenses qualified as deductible business expenses under IRC Sec. 162. The MBA degree did not satisfy minimum education standards of the taxpayer's existing position nor did it qualify him to perform a new trade or business. The basic nature of the taxpayer's duties did not significantly change after the educational program. The Tax Court reasoned that the MBA program improved preexisting abilities that the taxpayer had demonstrated. Additionally, the course of study did not lead to qualification for a professional certification or license.

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-mutual 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 deductions are reported on Schedule C. 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 phaseout 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.

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). 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).

Example 5E-1 Gambling loss deduction limited to gains.

Jimmy goes to Las Vegas several times a year to gamble. He is not a professional gambler. In 2009, he won $15,000 playing cards, but lost $23,000. The $15,000 of gambling winnings is reported on line 21 (Other income) of Form 1040. Jimmy'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 and is allowed for AMT. The remaining $8,000 of gambling losses are not deductible.

Variation: Assume that Jimmy gambles for his livelihood and is treated as being in the trade or business of gambling. Here, he reports his winnings and losses on Schedule C, but he can still only claim losses (or other expenses) to the extent of his winnings.

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.

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. 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:

1. The date and type of specific wager or wagering activity.

2. The name and address or location of the gambling establishment.

3. The names of other persons (if any) present with the taxpayer at the gambling establishment.

4. 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.

A recent IRS Chief Counsel memo addressed the issue of calculating and substantiating gambling winnings and losses for casual gamblers with gains and losses from slot machine play. According to the IRS, a taxpayer recognizes gain or loss from a wagering transaction at the time tokens are redeemed because trying to calculate the gain or loss after each individual transaction would be unduly burdensome and unreasonable. A casual gambler playing the slot machines throughout the day should determine the resulting gain or loss on a net daily basis, not on a wager-by-wager basis. Substantiation is still required and may be provided in the form of a chart or table summarizing the initial amount the taxpayer begins play with each time, the amount remaining at the time of each token "cash out," and gain or loss from each round of play.

Generally, the courts have been somewhat less restrictive in documentation for gambling losses. Following the rule of Cohan, the Tax Court allowed a taxpayer with no substantiation of his winnings or losses to claim a gambling loss based on the probability of a win and consideration of the taxpayer's lifestyle and meager financial position. However, in *Hardwick*, the Tax Court declined to apply the rule of Cohan because of the differing facts and circumstances, including financial position of the taxpayer. Though the taxpayer had kept a written record of his winnings and losses, the court found the records to be inadequate and thus limited his deductible loss. 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.

Selected Other Miscellaneous Itemized Deductions

Following is an overview of miscellaneous itemized deductions not covered elsewhere in this *Deskbook*. The information presented is general in nature and will provide an awareness of the important concepts.

Deducting IRA Losses

Traditional IRAs. Taxpayers who have incurred a loss in a traditional IRA can recognize the loss on their return, but only if (1) the full amount in all of the taxpayer's traditional IRAs has been distributed and (2) the total distributions are less than the unrecovered basis in all the IRAs. Therefore, taxpayers must have made nondeductible contributions to one or more traditional IRAs in order to create tax basis.

Roth IRAs. The rule for traditional IRAs applies also to Roth IRAs. All Roth IRA accounts must be distributed and the total distributions must be less than the unrecovered basis in the Roth IRAs. Contributions to Roth IRAs are always nondeductible, so taxpayers generally have basis in them (unless they have previously taken distributions equal to the basis, in which case the remaining balance is 100% earnings).

Claiming the Loss. Any allowable loss from a traditional or Roth IRA is deductible only as a miscellaneous itemized deduction. Therefore, such losses are deductible only for regular tax purposes and to the extent (when aggregated with all other miscellaneous itemized deductions) they exceed 2% of AGI. However, they are not deductible for alternative minimum tax purposes. Also, they are subject to the 3% of AGI phaseout for certain itemized deductions. (See the Introduction to this lesson.)

Example 5F-1 Deducting IRA losses.

Harold has one Roth IRA to which he has made a single contribution of $2,000. After its value drops to $750, he closes the account. He has a $1,250 loss ($2,000 – $750) deductible as a miscellaneous itemized deduction on Schedule A of Form 1040.

Wrap and Broker Fees

Investors often pay an investment firm a flat fee for investment services (a so-called wrap fee). Other times, they pay a set percentage of the account balance for ongoing investment advice. Rather than paying a separate transactional charge for items such as brokerage commissions, compensation to the financial consultant, custodial charges, and money manager fees, the taxpayer pays a single fee for all the services. CCA 200721015 states that these fees are not a "carrying charge" under Reg. 1.266-1(b)(1)(iv), and as such are not capitalized into the basis of the underlying stocks. Instead, they should be treated as a miscellaneous deduction under IRC Sec. 212 and deducted on Schedule A, subject to the 2% floor. In reaching this conclusion, the IRS noted that "consulting and advisory fees are not carrying charges because they are incurred independent of a taxpayer's acquiring property and because they are not a necessary expense of holding property."

Claim of Right Adjustments

When a taxpayer receives a payment to which he has an unrestricted right, he must include it in gross income. This is referred to as the claim of right doctrine. If, in a later year, it is determined the taxpayer has to repay the amount because he in fact did not have a right to it, he may not amend the prior year's return for the repayment. Instead, it must be reported as a deduction on the return for the year in which it is repaid. A deduction generally can be taken for a repayment of income received under a claim of right only if it is involuntary. Also, the claim of right doctrine may not be asserted by the taxpayer when the income at issue was originally obtained illegally or fraudulently.

Since a taxpayer must deduct the repayment in the year it is made, the deduction does not always provide a tax benefit equal to the tax paid in the earlier year. Repayments of $3,000 or less are deducted as miscellaneous itemized deduction subject to the 2% floor. However, if the repayment is greater than $3,000, IRC Sec. 1341 puts the taxpayer in the same position that he would have been in had the income never been received and the repayment never been made. The total tax for the year in which the deduction is allowed is the lesser of (1) the tax for the year computed with the deduction (claimed as a miscellaneous itemized deduction not subject to the 2% floor) or (2) the tax for the year computed without the deduction, less the amount of the prior year's tax that would have been saved had the income not been included that year.

Example 5F-2 Computing the tax on a claim of right repayment

In 2009, Robin, a single taxpayer, was required to repay $9,000 she had reported as income in 2007 under the claim of right doctrine. Her 2007 taxable income (including the $9,000) was $70,000, and her tax on that amount was $13,938. Her 2009 taxable income, without regard to the $9,000 repayment, is $40,000. Since her repayment exceeds $3,000, Robin must either reduce her tax for 2009 (the year of repayment) by the amount of tax she paid in 2007 that was attributable to the $9,000, or claim a deduction in 2009 for the repayment, whichever is more beneficial. In Robin's case, her tax will be lower if she reduces her 2009 tax for the 2007 tax attributable to the $9,000 of income, as shown in the following analysis:

1. Deduction of repayment on 2009 return—2009 tax on taxable income of $31,000 ($40,000 − $9,000)			$ 4,236
2. Reduction of 2009 tax by 2007 tax attributable to the $9,000 of income:			
a. 2009 tax on $40,000 on taxable income		$ 6,194	
b. 2007 tax on $70,000 of taxable income	$ 13,930		
c. Less: 2007 tax on $61,000 of taxable income	(11,680)	(2,250)	$ 3,944

Thus, Robin's 2009 tax is $3,944 (the lesser of line 1 or line 2). The reduction in 2007 tax should be reported on her 2009 Form 1040 as follows (IRS Pub. 525):

1. Include the gross 2009 tax of $6,194 on line 44 of Form 1040.

2. Include the $2,250 reduction in the 2007 tax as a payment on line 71 of the 2009 Form 1040, and write to the right of that amount "IRC Sec. 1341."

SELF-STUDY QUIZ

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

26. Aaron was involved in an auto accident during 2009. The accident resulted in a $3,400 decline in the fair market value (FMV) of his automobile. Aaron's basis in the automobile was $4,300 and his AGI was $20,000. Aaron did not have insurance on the automobile. How much is Aaron's casualty loss deduction?

    a. $900.

    b. $1,400.

    c. $2,300.

    d. $3,400.

27. Isabella had a theft loss of $8,000 in 2008, when her diamond ring was stolen. The ring was insured, but the insurance company refused to pay. Isabella expected to receive a check for $8,000 and did not deduct the loss in 2008. In 2009, the insurance company agreed to pay $6,000 in full settlement of the claim. Subject to the $100 (for 2008) and 10% of AGI rules, Isabella should report:

    a. $2,000 loss in 2008 (amended return).

    b. $2,000 loss in 2009.

    c. $8,000 loss in 2008 and $6,000 income in 2009.

    d. $8,000 loss in 2009.

28. Job search expenses are deductible:

    a. Only if the job search is successful.

    b. If the job is in a new business or field.

    c. If the taxpayer is an employee and seeks a job in the same field with self-employed status.

29. Nancy incurred $4,000 of employee travel expenses and was reimbursed $3,000 by her employer. Subject to any limits on meals and entertainment, Nancy should report:

    a. $3,000 income and $4,000 deduction for AGI.

    b. $1,000 deduction for AGI.

    c. $1,000 miscellaneous itemized deduction.

    d. Nothing.

30. Lucky Lewis is not a professional gambler, but he did win $125,000 betting on professional football games. Lewis also lost $140,000 betting on professional hockey games. Lewis should report:

    a. $125,000 of income and $125,000 itemized deduction not subject to the 2% floor.

    b. $15,000 itemized deduction.

    c. $15,000 deduction for AGI.

    d. $125,000 of income and $125,000 itemized deduction subject to the 2% floor.

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.)**

26. Aaron was involved in an auto accident during 2009. The accident resulted in a $3,400 decline in the fair market value (FMV) of his automobile. Aaron's basis in the automobile was $4,300 and his AGI was $20,000. Aaron did not have insurance on the automobile. How much is Aaron's casualty loss deduction? **(Page 163)**

    a. $900. [This answer is correct. According to the Internal Revenue Code, personal casualty losses are limited to the lesser of the decline in FMV or basis, less 10% of AGI, and less $500 for each separate casualty. $3,400 − $2,000 − $500 = $900.]

    b. $1,400. [This answer is incorrect. Personal casualty losses must be reduced by $500 (for 2009) per separate casualty.]

    c. $2,300. [This answer is incorrect. Personal casualty losses are limited to the lesser of the decline in FMV or basis. This answer choice does not properly reflect the calculation to determine the amount of the casualty loss.]

    d. $3,400. [This answer is incorrect. The decline in value is used, but the loss must be further reduced by a calculation before the proper deduction amount is revealed.]

27. Isabella had a theft loss of $8,000 in 2008, when her diamond ring was stolen. The ring was insured, but the insurance company refused to pay. Isabella expected to receive a check for $8,000 and did not deduct the loss in 2008. In 2009, the insurance company agreed to pay $6,000 in full settlement of the claim. Subject to the $100 (for 2008) and 10% of AGI rules, Isabella should report: **(Page 163)**

    a. $2,000 loss in 2008 (amended return). [This answer is incorrect. Generally a theft loss is deductible in the year incurred (discovered), but if insurance proceeds are expected, the taxpayer can elect to wait for final settlement.]

    b. $2,000 loss in 2009. [This answer is correct. Based on guidance in the IRS regulations, Isabella should deduct the loss when settlement is made, since she took no deduction in 2008.]

    c. $8,000 loss in 2008 and $6,000 income in 2009. [This answer is incorrect. Taxpayers do not amend returns when the settlement of a casualty occurs in a year subsequent to the year of the casualty or theft. Any adjustment or difference is recorded in the year of the settlement.]

    d. $8,000 loss in 2009. [This answer is incorrect. This answer choice does not properly reflect the correct amount of loss or the correct year for deduction.]

28. When are job search expenses are deductible? **(Page 166)**

    a. Only if the job search is successful. [This answer is incorrect. Job search expenses are deductible even if the search is unsuccessful or the job is offered and not accepted.]

    b. If the job is in a new business or field. [This answer is incorrect. For job search expenses to be deductible, the search must be in the same field as the employee's current employment.]

    c. If the taxpayer is an employee and seeks a job in the same field with self-employed status. [This answer is correct. Based on the outcome of a court case, as long as the job search is in the same field of work, being an employee or self-employed is not considered in determining deductibility.]

29. Nancy incurred $4,000 of employee travel expenses and was reimbursed $3,000 by her employer. Subject to any limits on meals and entertainment, Nancy should report: **(Page 168)**

    a. $3,000 income and $4,000 deduction for AGI. [This answer is incorrect. Employee business expenses are deducted for AGI only to the extent the reimbursement is included in income.]

    b. $1,000 deduction for AGI. [This answer is incorrect. Unreimbursed employee business expenses are not deducted directly from AGI]

    c. $1,000 miscellaneous itemized deduction. [This answer is correct. According to an IRS Revenue Procedure, employee business expenses in excess of employer reimbursement are a miscellaneous itemized deduction.]

    d. Nothing. [This answer is incorrect. Nancy is able to make a deduction related to the travel expenses described above. See the IRS Code includes specifics on deducting employee expenses.]

30. Lucky Lewis is not a professional gambler, but he did win $125,000 betting on professional football games. Lewis also lost $140,000 betting on professional hockey games. Lewis should report: **(Page 173)**

    a. $125,000 of income and $125,000 itemized deduction for gambling losses, not subject to the 2% floor. [This answer is correct. Gambling gains are taxable under the Code. Gambling losses are an itemized deduction, but are limited to gambling gains. The $125,000 loss is not subject to the 2% of AGI floor.]

    b. $15,000 itemized deduction. [This answer is incorrect. Gambling gains and losses are not netted out.]

    c. $15,000 deduction for AGI. [This answer is incorrect. Gambling gains and losses are not netted out and losses are not deductible for AGI.]

    d. $125,000 of income and $125,000 itemized deduction subject to the 2% floor. [This answer is incorrect. Gambling losses are not subject to the 2% of AGI floor.]

EXAMINATION FOR CPE CREDIT

Lesson 5 (TDBTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

26. Based on the following information, compute the taxpayer's 2009 personal casualty loss.

Cost	$ 10,000
Decline in FMV	$ 12,000
AGI	$ 60,000
Insurance reimbursement	$ 3,000

a. $500.

b. $1,000.

c. $2,500.

d. $7,000.

27. Job search expenses are:

a. Not deductible.

b. An itemized deduction subject to the 2% of AGI rule.

c. An itemized deduction not subject to the 2% of AGI rule.

d. Deductible for first-time employee job searches.

28. Which of the following itemized deductions is ***not*** subject to the 2% of AGI limitation?

a. Work-related education expenses.

b. Job search expenses.

c. Employee business expenses.

d. Personal casualty losses.

29. Gambling losses are:

a. Fully deductible as an itemized deduction.

b. Subject to the 2% of AGI limitation.

c. An itemized deduction, but are limited to gambling gains.

d. An itemized deduction, but are reduced by 10% of AGI and $500 per instance.

30. Robert, age 60, contributed $4,000 to a traditional IRA, but because of the limitations was only able to deduct $3,000. The value of the IRA fell to $2,000 and Robert cashed in the IRA. Robert will report a loss of:

    a. $2,000.

    b. $1,000.

    c. $500.

    d. None.

Lesson 6: Interest Expense

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. (See Example 6B-3.)

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.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:
- Describe the interest tracing rules and other rules related to interest expense.
- Calculate the deduction for various types of interest expense.
- Compute the investment interest expense deduction.

The Interest Tracing Rules

General Rules

The interest tracing concept under Temp. Reg. 1.163-8T is simple to apply if borrowings used for different expenditures are segregated in individual accounts or if debt proceeds are paid directly to a seller of property or provider of services. In these situations, the debt proceeds can be directly traced to a specific expenditure, and the interest expense related to the debt is classified by the nature of the expenditure. For example, interest expense on debt proceeds deposited into a bank account established and used solely for a Schedule C business will be treated as Schedule C business interest. Similarly, interest expense on a margin account held by a broker and used solely for purchasing securities generally will result in investment interest expense.

It becomes more complicated when funds from several loans and unborrowed amounts are commingled in a single account from which expenditures for various purposes are made. In this situation, Temp. Reg. 1.163-8T prescribes a series of allocation rules to match borrowings with expenditures. These rules are separately applied to each account and are summarized as follows:

1. If borrowed funds are deposited into an account already containing unborrowed funds, the borrowed funds are presumed to be expended first. Unborrowed funds deposited after borrowed funds will be presumed to be expended after the borrowed funds have been exhausted.

2. When borrowed funds from several loans are deposited into an account at different times, the funds from the earliest loan are presumed to be expended first (FIFO concept).

3. When borrowed funds from several debts incurred together are simultaneously deposited into an account, the taxpayer can select the order the funds are presumed to be deposited into the account. (No formal election is required.)

4. Except under the 30-day rule discussed in item 7, expenditures will not be attributed to borrowed or unborrowed funds deposited into an account after the expenditure.

5. Specific property securing specific debt is irrelevant in allocating debt to the various expenditure categories (except for home equity indebtedness). However, interest is *not* deductible to the extent the loan is secured by an obligation generating tax-exempt income or a single premium annuity contract.

6. Unexpended debt proceeds deposited in an account are presumed held for investment. As of the date the funds are spent, their character is reallocated based on the type of expenditure (passive, business, etc.). However, solely for reallocation purposes, the taxpayer can treat the expenditure as occurring on the later of the first day of the month the expenditure was made or the date the loan proceeds were deposited.

7. If an expenditure from an account (or from cash not held in an account) is made within 30 days before or after the deposit (or receipt in cash) of borrowed funds, the taxpayer can treat the expenditure as made from the borrowed funds (to the extent of such borrowed funds). This treatment overrides the result that would occur by applying the normal tracing rules. Choosing this treatment does not require a formal election by the taxpayer. However, taxpayers and preparers should document if the 30-day rule is used. This is discussed in more detail later in this lesson.

8. A special 90-day rule can be used for debt incurred to acquire, construct, or substantially improve a residence. This is discussed in more detail later in this lesson.

The following example illustrates these allocation rules for matching expenditures with borrowed and unborrowed funds.

Example 6A-1 Applying the tracing rules to an account with commingled funds.

On January 10, Louie opens a checking account, depositing $500 of proceeds of Debt A and $1,000 of unborrowed funds. The following chart summarizes the account activity during the year and the sources of expenditures under the interest tracing rules.

			Deposit (Use) of Funds					
Date	Amount	Transaction	Debt A	Debt B	Debt C	Unborrowed	Total	Account Balance
Jan. 10	$ 500	Debt A funds deposited	$ 500	$ —	$ —	$ —	$ 500	$ 500
Jan. 10	1,000	Unborrowed funds deposited	—	—	—	1,000	1,000	1,500
Jan. 11	500	Debt B funds deposited	—	500	—	—	500	2,000
Feb. 17	(800)	Personal expenditure	(500)	(300)	—	—	(800)	1,200
Feb. 26	(700)	Passive activity expenditure	—	(200)	—	(500)	(700)	500
Jun. 21	1,000	Debt C funds deposited	—	—	1,000	—	1,000	1,500
Nov. 24	(800)	Investment expenditure	—	—	(800)	—	(800)	700
Dec. 20	(600)	Personal expenditure	—	—	(200)	(400)	(600)	100

The following table lists Louie's expenditures and shows the proper treatment under the tracing rules.

Date	Expenditure	Treated as Made from[a]
Feb. 17	$800 personal	$500 Debt A funds $300 Debt B funds
Feb. 26	$700 passive activity	$200 remaining Debt B funds $500 unborrowed funds
Nov. 24	$800 investment	$800 Debt C funds
Dec. 20	$600 personal	$200 Debt C funds $400 unborrowed funds

Note:

[a] Borrowed funds used before unborrowed funds (FIFO order).

Assuming that, for reallocation purposes, Louie elects to treat expenditures as occurring on the later of the first day of the month expended or the day the funds were deposited, the interest for the year will be classified as follows:

Debt	Interest Category	Time Period
A	100% investment 100% personal	Jan. 10–Jan. 31 Feb. 1–Dec. 31
B	100% investment 60% personal, 40% passive	Jan. 11–Jan. 31 Feb. 1–Dec. 31
C	100% investment 80% investment, 20% personal	Jun. 21–Nov. 30 Nov. 1–Dec. 31

The tracing rules can often lead to an unfavorable classification of interest expense (e.g., personal interest). Particular attention should be paid to the 30-day and 90-day rules. These rules may allow the taxpayer to classify interest expense into a more favorable category (e.g., business interest) than under the literal application of the general tracing rules.

The 30-day Rule

The taxpayer can treat any expenditure from an account within 30 days before or after debt proceeds are deposited as made from the deposited debt proceeds, to the extent of such proceeds. This treatment, if chosen, overrides the general tracing rules and can be beneficial if it results in expenditures being treated as other than personal.

In addition, when a taxpayer receives debt proceeds in cash (i.e., the funds are not deposited in an account), the presumption is that they are used for personal expenditures. However, if the taxpayer makes a cash expenditure (including a deposit to an account) within 30 days before or after receiving the debt proceeds in cash, he can treat it as being made from the debt proceeds.

Special 90-day Rules for Expenditures on a Residence

Under the 90-day rule, taxpayers may treat debt as incurred to acquire a residence to the extent payments are made to acquire it within 90 days before or after the date the debt is incurred (IRS Notice 88-74). This rule overrides the general interest tracing rules of Temp. Reg. 1.163-8T (and the 30-day rule previously discussed).

In addition, when a residence is being constructed or substantially improved, debt incurred before the completion of the project can be treated as incurred to construct or improve a residence to the extent such expenditures are made no more than 24 months before the date the debt is incurred. Debt incurred within 90 days after completion of the construction or improvements can also be treated as incurred to construct or improve the residence to the

extent of any expenditure to construct or improve the residence made (1) no more than 24 months before the completion of the project, and (2) after completion up to the time the debt is incurred. This 90-day rule also overrides the result that occurs from a literal application of the interest tracing rules of Temp. Reg. 1.163-8T (and the 30-day rule).

For these 90-day rules, debt is incurred when loan proceeds are disbursed to or for the benefit of the taxpayer. Alternatively, a taxpayer may treat the loan application date as the date the debt is incurred, provided it is actually disbursed within a reasonable time after loan approval (i.e., generally 30 days).

The tracing rules may also impact other tax consequences in future years. In Moore, while not specifically dealing with interest tracing rules, the court noted that the taxpayer claimed residential interest expense on a vacation home that they were attempting to argue was investment property.

Using New Debt to Pay Accrued Interest

When new debt is used to pay accrued interest on other loans, it is allocated as are the loans generating the accrued interest.

Example 6A-2 Debt proceeds used to pay interest.

On January 1, Harry incurs a debt of $1,000 bearing interest at an annual rate of 10%, compounded annually, payable at the end of each year (Debt A). Harry immediately opens a checking account, into which he deposits the proceeds of Debt A. No other amounts are deposited in the account during the year. On April 1, Harry writes a check from that account for a personal expenditure in the amount of $1,000.

On December 31, he borrows $100 (Debt B) and immediately uses the proceeds of Debt B to pay the accrued interest of $100 on Debt A. From January 1–March 31, Debt A is allocated to investment expenditures because the account represents unexpended borrowed funds. From April 1–December 31, Debt A is allocated to the $1,000 personal expenditure.

Therefore, $25 of the interest on Debt A for the year is allocated to the investment expenditure, and $75 of the interest on Debt A for the year is allocated to the personal expenditure. Accordingly, for allocating the interest on Debt B for all periods until it is repaid, $25 of Debt B is allocated to the investment expenditure, and $75 of it is allocated to the personal expenditure.

Repayment Ordering Rules for Multiple-use Debt

Often the proceeds from a single debt will be allocated to several different categories of expenditures (i.e., personal, passive activity, trade or business, etc.). When such debt is partially repaid, ordering rules determine which category is deemed repaid first. Repayments are allocated to the various expenditure categories in the following order (which is favorable to taxpayers):

1. Personal expenditures.

2. Investment expenditures and expenditures for passive activities (other than rental real estate activities for which the taxpayer meets the active participation test).

3. Expenditures for rental real estate activities for which the taxpayer meets the active participation test.

4. Expenditures for former passive activities.

5. Expenditures for trade or business activities or certain low-income housing projects subject to favorable TRA '86 transition rules (as described in Act Sec. 502 of TRA '86).

To the extent new debt proceeds (the replacement debt) are used to repay another debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated using this repayment allocation scheme. The amount of replacement debt allocated to any such expenditure equals the amount of repaid debt allocated to such expenditure.

Example 6A-3 Repayment ordering rules for replacement debt.

Clarisse borrows $100,000 (Debt A) on July 12 and immediately deposits the proceeds in an account. She uses the proceeds to make the following expenditures:

Aug. 31	$40,000 passive activity expenditure #1
Oct. 5	$20,000 passive activity expenditure #2
Dec. 24	$40,000 personal expenditure #1

On January 19 of the following year, Clarisse borrows $120,000 (Debt B) and uses $90,000 of the proceeds to repay Debt A (leaving $10,000 of Debt A outstanding). In addition, Clarisse uses $30,000 of the proceeds of Debt B to make a personal expenditure (personal expenditure #2).

Using the ordering rules, Debt B is allocated $40,000 to personal expenditure #1, $40,000 to passive activity expenditure #1, $10,000 to passive activity expenditure #2 (based on the original allocation and repayment ordering rules of Debt A), and $30,000 to personal expenditure #2 (based on the actual use of Debt B proceeds).

Using the repayment ordering rules, Debt B expenditure categories will eventually be treated as repaid in the following order: (1) amounts allocated to personal expenditure #1, (2) amounts allocated to personal expenditure #2, (3) amounts allocated to passive activity expenditure #1, and (4) amounts allocated to passive activity expenditure #2.

Installment Sale Dispositions

When an asset with associated debt is sold in an installment sale, the tracing rules apply a special provision. The portion of the proceeds deferred via the installment sale is treated as allocable to an investment expenditure, while the use of the proceeds as they are collected is traced to determine if a reallocation of the underlying debt is necessary.

Example 6A-4 Debt reallocation after installment sale of asset.

Ann owns a building (previously used in her defunct proprietorship business) which she rented out for the last several years. On January 1, when Ann has $25,000 of debt remaining on the building, she sells it for $50,000 and receives $10,000 cash on that date. She will collect $20,000 on January 1 of each of the following years. Ann uses the $10,000 down payment to retire personal credit card obligations. At December 31 of the current year, she still owes the $25,000 debt related to the building she sold.

Because Ann used the down payment to pay personal expenditures, Ann's $25,000 of remaining debt attributable to her former building ownership is reallocated, with $10,000 now considered attributable to personal expenditures and the remaining $15,000 categorized as an investment expenditure. This produces the same outstanding debt allocated to investment property as if Ann had used the down payment to repay $10,000 of the debt on the building.

Example 6A-5 Categorizing interest expense upon installment land sale.

Bert is retired and owns a parcel of farmland that has been rented to an active farm operator. Bert has reported the rental income on Schedule E of his Form 1040 and against that rental income has deducted interest expense associated with debt attributable to the farmland. His remaining debt on the farmland is $80,000.

Bert sells the land for $150,000 using an installment sale. He receives $30,000 as a down payment, which he immediately applies to reduce his outstanding indebtedness. The remaining $120,000 of principal due on the sale will be paid equally over 10 years.

As Bert collects each annual installment payment, he applies the proceeds received to the underlying debt. During the duration of the contract, Bert reports interest and capital gain income on the installment sale. His

interest expense on the underlying land mortgage is recharacterized upon the sale and is deductible on Schedule A as investment interest, subject to the investment interest expense limitations.

Interest Expense That is Attributable to Pass-through Entities

IRS Notice 89-35 provides guidance on how to treat interest expense attributable to pass-through entities (i.e., partnerships and S corporations). Notice 89-35 supplements the interest tracing rules of Temp. Reg. 1.163-8T, which does not deal with (1) interest expense allocable to expenditures to acquire an interest in or make contributions to pass-through entities, or (2) interest expense incurred by pass-through entities from debt used to make distributions to owners.

Debt-financed Capital Contributions or Purchase Paid to a Pass-through Entity

According to IRS Notice 89-35, debt proceeds expended for a contribution to the capital of a pass-through entity (including the purchase of the interest or stock from the entity) are allocated by the owner in any reasonable manner. Reasonable methods include allocating the debt to the various types of assets of the entity or applying the interest tracing rules at the entity level to determine how the debt-financed capital contributions were spent. If owner-level debt is allocated to pass-through entity assets, any reasonable method is allowed. Reasonable methods per Notice 89-35 include using FMV, book value, or adjusted tax basis (reduced by debt allocated to the assets at the entity level) to make the allocation.

This debt allocation procedure results in the owner classifying the debt used to make the capital contribution as expended for the underlying trade or business, passive, or investment activities of the entity. Once the debt has been classified, the owner's interest expense is treated under the specific rules for trade or business, passive, and investment interest expense. See Example 6B-2 for a discussion of these rules. See Examples 6E-1 and 6E-3 for how to treat interest from owner-level debt used to acquire pass-through entity investments via capital contributions. See discussion on trade or business interest expense later in this lesson.

Debt-financed Acquisition of a Pass-through Entity Interest from Another Owner

IRS Notice 89-35 provides that owner-level debt used to purchase an interest in a pass-through entity from another owner (i.e., the entity does not receive the cash) must be allocated to the assets of the entity using any reasonable method. Reasonable methods include using FMV, book value, or adjusted tax basis (reduced by entity-level debt allocable to the assets) to make the allocation. Once the debt has been classified in this manner, the owner's interest expense is classified as attributable to the underlying trade or business, passive, or investment activities of the entity. The owner's interest expense is then treated under the specific rules for those categories of interest expense.

Example 6B-1 Acquisition of limited partnership interest from another owner.

Using borrowed money, Leonard acquired a 5% limited partnership interest from Leon for $25,000. The partnership owns rental properties with a FMV of $200,000 and an installment note receivable with a FMV of $100,000. The partnership also has debt of $100,000 allocable to the rental properties. How does Leonard treat the $3,000 of interest expense he incurred on the $25,000 debt used to acquire his limited partnership interest?

One reasonable method is for Leonard to allocate $12,500 of his debt to the partnership's rental property assets and $12,500 to the partnership's installment note receivable. This allocation is based on the $100,000 net FMV of the rental properties ($200,000 gross value less $100,000 partnership-level debt) and the $100,000 FMV of the installment note receivable. Thus, half of Leonard's debt is considered used to acquire passive rental property assets, and half is used to acquire investment (portfolio) assets. As a result, $1,500 of Leonard's interest expense is treated under the passive rules, and the remaining $1,500 is treated under the investment interest expense rules.

See Examples 6B-2 and 6E-2 for more on how to treat interest from owner-level debt used to purchase a pass-through entity investment from another owner.

Business Interest Expense Treatment for Debt Related to a Pass-through Entity

Based on the discussion in IRS Notice 89-35, interest expense on indebtedness used to purchase stock in an S corporation or a partnership interest, or to make a contribution to such entities, can be treated as fully deductible business interest expense if all of the following conditions are met:

1. The taxpayer materially participates in the partnership's or S corporation's business operations.

2. The partnership's or S corporation's assets are used solely in conducting an active trade or business and not for passive or portfolio activities.

3. No debt-financed distributions to partners or shareholders have been made. (However, interest from debt used to make distributions may be fully deductible as business interest. See Examples 6B-3 and 6B-4.)

Trade or business interest expense incurred in connection with interests in partnerships or S corporations should be reported on Part II of Schedule E. Per IRS Notice 88-37, the interest expense should be reported on a separate line and identified as "business interest" with the name of the pass-through entity indicated. For partnerships, this interest would presumably also reduce self-employment (SE) income from the pass-through entity and therefore reduce SE tax. Interest that cannot be fully deducted as business interest based on these rules is subject to the interest allocation rules discussed in the preceding paragraphs.

Example 6B-2 Reporting active business interest expense from purchase of S corporation stock.

John incurred $20,000 of interest expense on debt used to purchase stock in Horse Scents, Inc. from another shareholder. All of the S corporation's assets were used in conducting its trade or business. John meets the material participation criteria for its business, and Horse Scents has not made any debt-financed distributions to owners. Horse Scents sent John a Schedule K-1 showing a $1,000 loss (exclusive of his outside interest expense).

Under Notice 89-35, the entire $20,000 is deductible as business interest expense. Per Notice 88-37, John should deduct it on a separate line of Schedule E, showing the amount as "business interest" with the S corporation's name listed alongside the description.

If the trade or business of the partnership or S corporation is passive by definition (i.e., rental activities, except for rental real estate activities materially participated in by real estate professionals), or if the taxpayer is treated as not materially participating in its business, the interest expense is treated under the passive activity rules of IRC Sec. 469. (See Example 6E-5 for the treatment of interest expense attributable to oil and gas working interests.)

Entity Financing Distributions to Owners

IRS Notice 89-35 also provides rules for determining the treatment of pass-through entity debt used to make distributions to owners. To the extent the entity has not already allocated debt to its expenditures, the entity may allocate debt actually used for distributions to such expenditures. If the entity does not or cannot allocate debt to entity-level expenditures other than distributions, the entity-level interest expense must be separately reported to the owners, and the owners must determine the treatment of the interest expense based on the tracing rules applied at the owner level.

Example 6B-3 Debt-financed partnership distribution.

Happyacres Limited Partnership owns rental real estate. In the current year, Happyacres had positive cash flow of $100,000. It used the money to make capital improvements and then took out a $200,000 second mortgage on the property. Happyacres then distributed $200,000 to its limited partners. Other than the $100,000 capital expenditure and the $200,000 distribution, Happyacres had operating expenses of $1.2 million. Using the debt allocation option, Happyacres allocated the $200,000 debt to its operating expenditures and reported the interest expense on its investors' Schedules K-1 as part of an overall rental activity loss.

The partners will treat the entire rental activity loss (including the deduction for the interest expense) reported on their Schedules K-1 in accordance with the passive loss rules (i.e., the loss is passive or active depending

on the participation of the partner). No special treatment is required for the interest expense from the partnership-level debt used to pay distributions because Happyacres was able to allocate the $200,000 debt to partnership expenditures under Notice 89-35.

Example 6B-4 Debt-financed partnership distribution—interest expense requires special treatment by partners.

Assume the same facts as in Example 6B-3 except Happyacres borrowed $1.5 million to pay for the operating expenses, capital improvements, and distributions. Therefore, it could not allocate the $200,000 debt used to pay distributions to partnership expenditures (because other debt was already allocated to such expenditures).

Here, Notice 89-35 mandates that the partnership separately report on each partner's Schedule K-1 his allocable share of the interest expense for debt used to fund distributions. The partners must then use the tracing rules to determine the use of the debt-financed distribution proceeds. For example, if, under the tracing rules, a partner uses the distribution proceeds for personal purposes, the separately reported interest expense must be treated as nondeductible personal interest expense at the partner level.

Debt Attributable to Former Pass-through Entities

Temp. Reg. 1.163-8T and IRS Notice 89-35 are silent about the treatment of interest paid when a partner disposes of a partnership interest yet retains debt attributable to the original acquisition of that pass-through entity. However, some of the principles established throughout these authorities give guidance. For example, if a taxpayer sells his interest in a pass-through entity and receives an installment note, the interest in the pass-through entity is converted into an investment asset (i.e., the debt security receivable), and any remaining interest expense is investment interest. However, the results are less clear when a pass-through entity simply fails or becomes worthless, and no sale occurs. In this case, it seems reasonable to continue characterizing the interest expense in the same manner used in the most recent tax year before the worthlessness or other disposition of the pass-through entity.

Example 6B-5 Interest expense after disposition of passive activity.

Barb was a 25% shareholder of an S corporation. The S corporation operated an active business, and all of its assets were used in this business activity. Accordingly, the interest expense that Barb paid annually on the debt allocable to her purchase of the S corporation stock was treated as business interest on page 2 of Schedule E within her Form 1040, in accordance with IRS Notice 89-35. When the S corporation failed, Barb continued to pay interest on her debt for several years following termination of the S corporation business. Presumably, she should continue to treat the interest expense as business interest. However, if the S corporation retained any assets that were converted to other nonbusiness uses, the character of Barb's interest expense would change, based on the use of these assets.

Capitalized Interest Expense via Pass-through Entity

Under the uniform capitalization rules, interest on debt allocable to the production of *qualified property* must be capitalized. Such property includes (1) all real estate, (2) depreciable personal property with a depreciable life exceeding 20 years, and (3) property with a production period exceeding two years (or one year if costs exceed $1 million).

For pass-through entities, the interest capitalization requirements are applied first at the entity level and then at the owner level (either a partner, shareholder, or beneficiary treated as the owner of a grantor trust). If production at the pass-through entity level requires interest capitalization and the entity's production costs exceed the debt directly related to the production plus its other debt (i.e., avoided-cost debt), the excess production costs are allocated to the owners. When this occurs, the owner may need to capitalize interest expense incurred at the owner level.

Notice 88-99 provides similar rules when the owner produces property subject to interest capitalization. Here, an owner that is allocated interest expense from a pass-through entity may need to capitalize some or all of the interest if his own production costs exceed the debt directly related to the production plus the avoided-cost debt.

Interest expense capitalized under either of these circumstances generally is recovered as is the related produced asset (i.e., through depreciation or cost of goods sold).

Fortunately, the IRS provides *de minimis* rules that exclude many entities and their owners from applying these interest capitalization rules. If the entity is engaged in production activities, the rules will not apply to the owner if (1) he owns 20% or less of the entity (capital ownership for partners and direct or indirect stock ownership for shareholders of S corporations), and (2) the production expenditures allocated to the owner, after reductions for the entity's traced and avoided-cost debt, are $250,000 or less. Similarly, when a 20% or less owner is engaged in production activities and receives pass-through interest of less than $25,000, the interest capitalization rules will not apply to the interest expense of the pass-through entity.

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. The tracing rules discussed earlier identify interest allocable to these types of expenditures. 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 lesson).

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 6C-1 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. Given that at least six Circuit courts (the 4th, 5th, 6th, 7th, 8th, and 9th Circuits) and the Tax Court 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

Only for qualified residence interest is the property securing the debt important in determining the tax treatment of the related interest expense. Qualified residence interest expense on up to $1 million ($500,000 for married filing separately) of acquisition indebtedness plus up to $100,000 ($50,000 for married filing separately) of home equity indebtedness is fully deductible for regular tax (but not necessarily for AMT) unless the itemized deduction phase-out rules apply. Acquisition and home equity indebtedness must be secured by a qualified residence. By following these rules, a taxpayer can generally, but not necessarily for AMT, borrow $1.1 million on qualified residences for which the interest expense is deductible. To fully understand the rules for qualified residence interest, the following terms must be defined: (1) qualified residence; (2) acquisition indebtedness; (3) home equity indebtedness; (4) secured debt.

Mortgage interest is only deductible when paid by the taxpayer who is the legal or equitable owner of the property. Thus, a taxpayer cannot deduct interest he pays on the mortgage of another. This may occur, for example, if parents make mortgage payments for their adult children. Similarly, a taxpayer who holds a mortgage generally cannot deduct the interest if it is paid by another person. However, interest paid on the taxpayer's indirect debt obligation combined with equitable and beneficial ownership of the residence may be deductible. Here, taxpayers were unable to obtain a mortgage due to their poor credit rating. A related party obtained a mortgage and held title to the taxpayer's home. The taxpayer made all the mortgage payments and bore all economic responsibilities of owning the home, which was the primary residence.

What Is a Qualified Residence?

A *qualified residence* can be the taxpayer's principal residence (defined later) and one other residence selected by the taxpayer for the tax year. *Principal residence* has the same meaning as under IRC Sec. 121, dealing with the home sale gain exclusion. When a taxpayer uses more than one home as a residence throughout the year, the home that is used the most during the year generally is the principal residence. If that test is not conclusive, other relevant factors for determining the principal residence include (but are not limited to): (1) the taxpayer's place of employment; (2) where the family members make their place of abode; (3) the address shown on the taxpayer's tax returns, driver's license, automobile registration, and voter registration card; (4) the mailing address for bills and correspondence; (5) the location of the taxpayer's banks; and (6) the location of religious organizations and recreational clubs with which the taxpayer is affiliated.

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.

Example 6D-1 Deducting mortgage interest when more than two eligible homes exist.

Steve and Shirley 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. Neither of the vacation homes are rented. Steve and Shirley 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.

For regular tax purposes, a residence includes (1) a house, (2) a condominium, (3) a mobile home, (4) a boat, (5) a house trailer, or (6) other property that under all facts and circumstances can be considered a residence. Items (1)–(5) must have sleeping, lavatory, and cooking facilities. (Thus, a houseboat could be considered a second residence, but a ski boat could not.) Vacant land used for occasional camping does not qualify as a residence.

When a residence is rented for part of the year, it is treated as a qualified residence only if the taxpayer uses it for personal purposes for a number of days that exceeds the greater of:

1. 14 days, or

2. 10% of the number of days the unit was rented at a fair rental rate.

If a second residence is not rented (or held out for rent) during the year, it qualifies even if the taxpayer has no days of personal use during the year.

If a home is not a personal residence (i.e., too many rental days and not enough personal-use days), it is treated as rental property, and all expenses (including interest) are allocated between rental use and personal use. The income and expenses attributable to rental use are deductible, subject to the passive activity, hobby loss, and at-risk limitations. The expenses attributable to personal use (including mortgage interest) are treated as personal. Therefore, the personal-use portion of the interest expense is nondeductible.

A residence under construction can be treated as a qualified residence for up to 24 months, but only if it actually becomes a qualified residence when it is ready for occupancy. A lot does not qualify as a residence under this rule until construction begins. Interest on debt to acquire the lot that is incurred before construction begins would be personal interest. However, that interest could be deductible if a home equity loan is used to acquire the lot. Also, if the taxpayer can demonstrate that, before beginning construction of the residence, the lot had been held as an investment, interest incurred before construction begins would qualify as investment interest expense. However, taxpayers making this argument should be prepared for an IRS challenge and informed that proving investment intent can be difficult, especially if the property is ultimately used for another purpose.

Acquisition Indebtedness

Acquisition indebtedness is debt secured by a qualified residence (including a designated second residence) not in excess of $1 million ($500,000 for married filing separately). Acquisition indebtedness proceeds must be traceable to expenditures to acquire, construct, or substantially improve a qualified residence. See Example 6D-4 for the special 90-day rule exception to literal application of the tracing rules for expenditures on a residence.

Example 6D-2 Vacation home under construction.

Mark and Becky borrowed $100,000 to purchase a lake lot on July 1, 2008. Construction began on January 1, 2009, and the house was completed on July 1, 2009 with the proceeds of an additional $150,000 loan. They stayed in the house 25 days and rented it for 42 days during the second half of 2009. Both the $100,000 debt to buy the lot and the $150,000 debt to construct the house were secured by the lake property at all times. Their principal residence is burdened by acquisition indebtedness of $400,000.

The lake house was completed in under 24 months, and Mark and Becky used it themselves for more than the greater of 14 days or 10% of the time it was rented after it was ready for occupancy in 2009. Therefore, the lake house meets the definition of a qualified residence starting on the date that construction began (January 1, 2009). From that date forward, all debt expended on the house and the lot is treated as acquisition debt and generates fully deductible qualified residence interest because the combined acquisition debt on their two residences is less than the $1 million limitation.

The interest on the $100,000 debt to acquire the lot is treated as personal interest for the period before construction commenced on January 1, 2009.

Acquisition indebtedness also includes debt used to refinance earlier indebtedness that meets this definition of acquisition indebtedness, but only to the extent of the balance of the original acquisition indebtedness at the time of refinancing. See Example 6D-5.

If acquisition indebtedness exceeds the $1 million limit *at any time* during the year, the taxpayer must calculate the amount of deductible qualified residence interest subject to the limit. This requires a computation of the average balances of each mortgage during the year. Lenders' monthly statements showing the average balance may be used. If this information is not provided, the IRS lists two optional methods to compute average mortgage balances of each mortgage in IRS Pub. 936: (1) average of first and last balance, and (2) interest paid divided by interest rate. The average-of-first-and-last-balance method can be used only if no new amounts were borrowed on the mortgage during the year, there were no more than one month's of principal prepaid during the year, and only level payments at fixed equal intervals on at least a semi-annual basis were made (adjustments for changes in interest rate are

acceptable). The interest-paid-divided-by-interest-rate method is available if at all times during the year the mortgage was secured by a qualified residence and the interest was paid at least monthly. See Example 6D-6 for an illustration showing how to calculate the deductible amount of qualified residence interest when acquisition indebtedness exceeds the $1 million limit.

For AMT purposes, interest expense from refinancing debt is deductible only to the extent the amount of the loan principal is not increased or, if the loan principal is increased, any additional amount is used to acquire, construct, or substantially improve any property that was a principal residence or a qualified residence. Rev. Rul. 2005-11 clarified that this treatment is also applicable for interest on a loan with multiple refinancings.

Outstanding mortgage debt obtained on or before October 13, 1987 (i.e., grandfathered debt) is not subject to these restrictions. As long as the debt was originally secured by the residence and continues to be secured by it, there is no limit on the amount of debt that was incurred and no restrictions on the use of the debt proceeds. However, such outstanding indebtedness reduces the $1 million acquisition debt ceiling dollar for dollar for debt incurred after October 13, 1987. Any debt that refinances grandfathered debt is also grandfathered to the extent of the pre-October 13, 1987 debt's outstanding balance on the refinancing date. However, a refinancing (either of the original debt or a grandfathered refinancing) generally is grandfathered only through the original due date of the grandfathered debt (see Example 6D-5). The only exception is if the pre-October 13, 1987 debt was not amortizable over its term (i.e., a balloon note). A refinancing of that debt is grandfathered for the shorter of 30 years from the date of the first refinancing or the first refinancing's original term.

Home Equity Indebtedness

Home equity indebtedness is debt (other than acquisition debt) secured by a qualified residence. It generates fully deductible qualified residence interest, but only to the extent it does not exceed the lesser of:

1. $100,000 ($50,000 for married filing separately), or

2. the FMV of the residence less acquisition indebtedness (including pre-October 14, 1987 grandfathered acquisition indebtedness).

The only restrictions on home equity indebtedness are the $100,000 (or FMV) cap and the requirement that the debt be secured by a qualified residence. There is no limit on the number of qualified home equity loans (for example, the taxpayer may have three loans that in the aggregate are under the $100,000 or FMV limitation). The actual use of the debt proceeds is irrelevant unless they are used to purchase or carry tax-exempt obligations. Interest on indebtedness used to purchase or carry tax-exempt obligations is not deductible. The home equity indebtedness category represents an exception to the general rule that tracing the use of debt proceeds determines the tax treatment of interest expense. However, the use of the proceeds may be relevant for AMT.

If the proceeds of a home equity loan are used exclusively for qualified educational expenses, the loan is also a qualified education loan under IRC Sec. 221. Interest expense on a home equity loan that is also a qualified education loan should be reported to the borrower on Form 1098E (Student Loan Interest Statement) if he or she certifies (typically on Form W-9S) that all proceeds will be used for qualifying educational expenses. This will be advantageous since some or all of the interest can then be deducted above the line. Presumably, any interest paid on such a loan in excess of the allowable student loan interest deduction can still be deducted on Schedule A as home equity interest.

Secured Debt

For a debt to qualify as acquisition or home equity indebtedness, it must be secured by a qualified residence. Debt is secured by a qualified residence only if:

1. the residence is specific security for payment on the debt;

2. in the event of default, the residence could be foreclosed on to satisfy the debt; and

3. the security interest is recorded or otherwise perfected under state law, whether or not the deed is recorded.

State or local homestead laws that render the security interest ineffective or restrict its enforceability will not cause the debt to fail these security requirements. Furthermore, the debt can be secured by other assets (e.g., a car, a bank account, stock) in addition to the residence without jeopardizing the security requirement. However, interest is not deductible to the extent the debt is secured by a single premium annuity contract or an obligation generating tax-exempt income even if the residence is also used as security.

Example 6D-3: Debt must be secured by acquired residence—not just any residence.

Jim and Mary borrow $250,000 secured by their primary residence. They use the funds to build a vacation home in the mountains. Interest on $100,000 of their loan is deductible as "Home Equity Indebtedness". In order for the interest on the entire loan to be deductible, the loan would have to be secured by the new vacation home.

Example 6D-4 Special 90-day rule for qualified residence acquisition debt.

In August 2009, Bob and Debbie paid $200,000 cash for a vacation home. The vacation home is now their second residence. In October 2009, they took out a $150,000 personal loan for personal expenditures.

Because the debt was incurred within 90 days before or after the expenditure to acquire a qualified residence, Bob and Debbie can treat the loan as used to acquire the vacation home even though the funds were spent on personal expenditures. To convert the $150,000 into qualified residence debt that generates fully deductible interest expense, Bob and Debbie must have the lender secure it with the vacation home, or they can take out a new $150,000 mortgage on the home and pay off the other loan. Starting on the date the $150,000 debt is secured by the residence, the interest expense is characterized as qualified residence interest.

Interest on Home Mortgage Not Meeting Qualified Residence Interest Definition

In some cases, taxpayers may have indebtedness secured by one or more personal residences that exceeds the amount that can be treated as qualified residence debt. This could happen if (1) residence debt is refinanced and the new debt exceeds the amount of the old debt, (2) the taxpayer owns very expensive residential property, or (3) the taxpayer owns more than two residences burdened by debt.

If the excess debt is traceable (see earlier discussion of the tracing rules) to expenditures for personal residence property, the interest expense is treated as nondeductible personal interest. If the debt is traceable to other expenditures, the interest is treated under the various rules for personal, trade or business, passive activity, or investment interest, depending on the use of the proceeds as determined by the tracing rules. The fact that debt in excess of the ceiling on qualified residence debt is secured by a qualified residence is irrelevant in determining the tax treatment of the related interest expense.

Example 6D-5 Refinancing of acquisition indebtedness.

Dick and Marijane purchased their California home in 1981 for $200,000 by putting $50,000 down and taking out a $150,000 mortgage. The home appreciated rapidly in the 1980s and, in July 1987, they refinanced by taking out a new 20-year $350,000 mortgage. The final payment on this mortgage was due August 1, 2007. The home continued to appreciate and, in December 1993, Dick and Marijane again refinanced the home by taking out another mortgage—this time for $500,000. The balance of the 1987 mortgage was $325,000 at the time of the 1993 refinancing. Each time they refinanced, Dick and Marijane spent the amount in excess of what was necessary to pay off the old mortgage on personal expenditures.

The $350,000 mortgage taken out in 1987 qualified as pre-October 14, 1987 grandfathered debt. The 1993 mortgage to the extent used to refinance that grandfathered debt also qualified as grandfathered debt, until the due date of the original loan. Thus, $325,000 of the $500,000 mortgage was automatically treated as acquisition indebtedness until August 2007. The excess of the $500,000 mortgage over the amount treated as acquisition indebtedness qualifies as home equity indebtedness to the extent of $100,000 (assuming no limitation due to FMV of the home). IRS Notice 88-74 clarifies that a single debt can be both acquisition indebtedness and home equity indebtedness. The remaining $75,000 of the $500,000 mortgage cannot be traced to anything other than personal expenditures, and the interest on that amount will be treated as personal. In summary, the interest expense on the $500,000 home mortgage will be treated as follows:

1. Interest on $100,000—qualified residence home equity indebtedness regardless of how debt proceeds actually spent.

2. Until August 2007, interest on $325,000—qualified residence acquisition indebtedness under the pre-October 14,1987 grandfather rule.

3. Interest on $75,000—personal interest under the tracing rules.

Even though interest on $325,000 of the debt is not deductible as mortgage interest after August 1, 2007, since that was the original due date of the grandfathered debt, interest on $100,000 will continue to qualify as home equity indebtedness.

Example 6D-6 Acquisition indebtedness exceeds $1 million.

Jim and Nancy own both a principal residence and a second home that they do not rent out. Each residence was mortgaged when purchased (both after October 13, 1987) and is the security for each one's respective mortgage. Jim makes equal monthly payments of principal and interest on each mortgage. Loan #1 (on the principal residence) had a balance at the beginning and ending of the year of $800,000 and $740,000 respectively and a fixed 6% rate. Loan #2 (on the second home) had a balance at the beginning and ending of the year of $400,000 and $320,000 respectively and a fixed 7% rate. Consequently, Jim and Nancy's acquisition indebtedness for purposes of the qualified residence interest expense exceeds the $1 million limit for the year. Jim paid $45,000 in interest on Loan #1 and $25,550 in interest on Loan #2 for the year. Their deductible residence interest expense is calculated under the various options for computing average balances on the loans as follows:

Methods of Computing Average Balances	**Loan #1**	**Loan #2**	**Total**
1. Average of first and last balance—			
Balance at January 1	$ 800,000	$ 400,000	$ 1,200,000
Balance at December 31	740,000	320,000	1,060,000
Average	$ 770,000 **(A)**	$ 360,000 **(A)**	
2. Interest paid divided by interest rate—			
Interest paid for the year (1)	45,000	25,550	$ 70,550
Annual interest rate (2)	6%	7%	
Average balance (1) ÷ (2)	$ 750,000 **(B)**	$ 365,000 **(B)**	
3. Statements provided by lender— Year's average of each month's closing mortgage balance, as provided by the lender	$ 760,000 **(C)**	$ 362,000 **(C)**	
Average Mortgage Balance for the year— lowest of **(A)**, **(B)**, or **(C)**	$ 750,000 **(B)**	$ 360,000 **(A)**	$ 1,110,000

Deductible Residence Interest Expense:

Acquisition indebtedness limit	$ 1,000,000	**(D)**
Total of average balances of both mortgages	1,110,000	**(E)**
(D) ÷ **(E)**	.901	
Total mortgage interest paid for the year	× 70,550	
Deductible residence interest expense for the year	$ 63,566	

Electing out of Treatment as Qualified Residence Debt to Maximize Interest Deductions

As discussed previously, taxpayers can deduct interest expense on up to $100,000 of home equity indebtedness secured by a qualified residence. The interest is fully deductible for regular tax purposes regardless of the actual

use of the home equity debt proceeds. However, home equity debt proceeds may be used in a manner that allows for fully deductible interest expense apart from being qualified residence interest (e.g., when used in a Schedule C business activity). Here, it would be better to treat the interest expense under the general tracing rules rather than under the home equity debt rules. This allows a taxpayer to save the home equity debt interest deduction for another home equity debt or, for taxpayers who do not itemize deductions, to take a deduction that would otherwise go unused. It may also shift the deduction from being an itemized deduction to one that decreases AGI (affecting various AGI-sensitive items) and reduces self-employment (SE) tax.

Taxpayers can irrevocably elect to treat debt as not secured by a qualified residence [Temp. Reg. 1.163-10T(o)(5)]. The impact of this election is that the general tracing rules of Temp. Reg. 1.163-8T apply to determine the tax treatment of the interest expense. The regulations are actually silent as to whether a formal election is necessary.

Example 6D-7 Electing out of home equity debt treatment.

Rex borrows $100,000 by taking out a loan secured by his principal residence. Rex deposits the loan proceeds into an account used by his sole proprietorship in which he actively participates. The money is immediately spent on a new computer and printing equipment for the business.

If Rex elects out of home equity debt treatment and uses the general tracing rules, the interest expense from the $100,000 loan will be 100% deductible as business interest on his Schedule C. The interest expense will reduce both his regular tax and his SE tax. It will also decrease AGI, which may increase AGI-sensitive deductions and credits. If Rex treats the $100,000 loan as home equity debt, the interest will be deductible as an itemized deduction for regular tax (subject to the itemized deduction phase-out rules). Furthermore, Rex will have used up his $100,000 home equity debt tax benefit.

Deducting Mortgage Loan Points

Points charged for the use of money are deductible as qualified residence interest expense if associated with qualified residence acquisition indebtedness or home equity indebtedness. For this purpose, points include amounts (1) designated as such on a closing statement (and referred to as either loan origination fees, loan discount, discount points, or points); (2) computed as a percentage of the loan amount; and (3) charged under the established business practice in the area the residence is located. Amounts designated as points in lieu of amounts normally separately stated on the closing statement (e.g., appraisal fees, inspection fees, attorney fees, or title fees) are not deductible as points.

Current Deduction or Amortization? In general, IRC Sec. 461(g) requires that prepaid interest (which includes mortgage loan points) be amortized and deducted over the life of the loan using some reasonable method (e.g., straight-line or in proportion to principal payments). However, IRC Sec. 461(g)(2) provides an exception that allows cash-basis taxpayers to deduct prepaid points upon payment if:

1. the points are paid on indebtedness incurred from the *purchase, construction*, or *improvement* of the *principal* residence (second home or home equity loan points do not qualify); and

2. the indebtedness is secured by a principal residence, charging points is an accepted business practice, and the points charged are not excessive in relation to normal business practices.

If the points are related to debt on a second home that meets the definition of a qualified residence, they must be amortized over the life of the loan because a current deduction for prepaid points is allowed only if the related debt is incurred for the purchase, construction, or improvement of, and secured by, the *principal* residence. However, no prohibition exists on the current deductibility of points under IRC Sec. 461(g) for a principal residence that is also used (either partially or substantially) for rental purposes.

Direct Payment Requirement. Points are deductible (either currently or via amortization) only to the extent they are paid (or deemed paid) by the taxpayer. In connection with the *purchase* of a principal residence, all amounts paid by the taxpayer in connection with the closing are treated as if applied to the points charged. Taxpayers are deemed to have paid points directly to the extent of (1) down payments, (2) escrow deposits, (3) earnest money applied at closing, and (4) other amounts actually paid at closing. However, it appears this rule applies only to purchases of

principal residences; points paid for the *improvement* of a principal residence must be paid from separate funds the taxpayer brings to the loan closing to be deductible.

The buyer is treated as having paid seller-paid points if he reduces his basis in the residence by the amount of those points. This means the buyer can currently deduct the seller-paid points if the other rules for current deduction are satisfied.

Example 6D-8 Deducting points paid when purchasing a principal residence.

Robert and Susie Landers 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 Landers the home paid one point ($1,000) to help them get their mortgage.

The point the Landers were charged is deemed paid and fully deductible. In addition, the Landers 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.

Refinancing a Principal Residence. Points paid for a mortgage refinancing are not deductible when paid but, instead, must be capitalized and amortized over the term of the new loan. Amortization is computed ratably based on the number of periodic loan payments made in the tax year to the total periodic payments for the term of the loan. If the loan is paid off prior to maturity (e.g., the residence is sold and the loan paid off, or the loan is refinanced), the remaining unamortized balance of the points can be deducted in that tax year. If the mortgage loan is refinanced with the same lender, the unamortized points on the first loan must generally be deducted over the term of the new loan. But, if the borrower paid an amount at least equal to the points at closing of the first refinancing (i.e., the loan to which the unamortized points relates) and that loan is subsequently refinanced with a different lender, it appears that the unamortized points can be deducted in the year of the subsequent refinancing. This is similar to the rule that allows cash-basis taxpayers to deduct expenses that are paid with borrowed funds, as long as the funds are not borrowed from the provider of the goods or services that give rise to the expense.

Example 6D-9 Points paid for refinancing a principal residence loan.

Bum refinanced his $150,000 mortgage on his principal residence at a lower interest rate, paying two points ($3,000) to do so. He paid the points out of his own funds at closing (i.e., they were not added to the debt). All of the proceeds of the new loan were used to pay off the old loan. Since the old loan represented acquisition indebtedness, the new loan is treated the same way. Since the loan proceeds were not used for purchasing or improving the residence, the points paid by Bum on the new loan do not meet the requirements of IRC Sec. 461(g)(2) and thus are not currently deductible. They must be amortized over the term of the loan.

Variation: If Bum had borrowed $200,000 and used $50,000 on improvements to his residence and the remaining $150,000 to refinance his old loan, 25% of the points would be deductible in the year paid. The remaining points would be amortizable over the term of the loan.

While it is clear that points paid in a traditional refinancing (i.e., long-term mortgage loan is refinanced with one at a lower interest rate) are not currently deductible, the deductibility of points paid on other types of refinancing is less certain. The Tax Court approved fully deducting points charged on refinancing when the taxpayers obtained a lower mortgage rate and used the savings to fund further improvements in connection with their principal residence over the course of four years. The IRS claimed the points should be amortized over thirty years. However, the Tax Court felt Congress' intent of "in connection with" should be broadly construed. Thus, under IRC Sec. 461(g)(2), the taxpayers were allowed to deduct the full amount of the points in the year of refinancing even though the improvement was not completed until later.

In *Huntsman*, points were paid to refinance a three-year note used to purchase a principal residence. The Court concluded that it was obvious that obtaining a three-year loan was merely an integrated step in securing the permanent financing to purchase the home. Thus, points paid on the refinancing were considered to be paid in connection with the purchase of the taxpayer's home and deductible in the year paid. This rationale should also

apply to taxpayers who refinance a bridge loan or construction loan, at least within the jurisdiction of the 8th Circuit (AR, IA, MN, MO, NE, ND, and SD). The IRS has stated that it will not follow the *Huntsman* decision outside of the 8th Circuit.

Reverse Mortgage Loans

In a reverse mortgage loan, the lender commits to a principal amount not to exceed a percentage of the current appraised value of the residence, which is paid to the borrower in installments over a period of months or years. The loan is secured by a mortgage on the borrower's principal residence. Repayment of the loan is due when the principal amount has been fully paid to the borrower, the residence that secures the loan is sold, the borrower dies, or the borrower ceases to use the home as his or her principal residence. The loan agreement may provide that interest is added to the outstanding loan balance monthly as it accrues. The outstanding loan balance is the current amount of money owed by the borrower to the lender and includes the total of the installments paid by the lender to date and the total accrued interest to date.

Assuming all other requirements of IRC Sec. 163(h) have been met, the interest is deductible by the borrower when actually paid by the borrower; not when interest is added to the outstanding loan balance. A reverse mortgage is generally a home equity loan so the limits discussed earlier in this lesson on home equity indebtedness apply.

Example 6D-10 Deducting interest on reverse mortgage loans.

Jim, 45, enters into a reverse mortgage with his 65-year-old father, Bob, whereby Jim will pay Bob $750 per month for the next five years. Jim has a security interest in Bob's principal residence, which has been appraised at $60,000. Interest will accumulate monthly at the applicable federal rate and is added to the principal balance. Bob will owe the entire balance (including interest) at the end of the 5-year term. Assuming Bob continues to use the home as his principal residence for the entire 5-year period, Bob can deduct the interest only when it is paid at the end of the 5-year period.

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 (see later discussion) and is effective for amounts paid or incurred in 2007–2010 (2007 Mortgage Relief Act). In effect, these amounts paid for *qualified mortgage insurance* premiums are treated as a separate category of qualified residence interest. Box 4 of Form 1098 has been added to report the amount of qualified mortgage insurance premiums paid by the taxpayer.

Qualified mortgage insurance is: (1) mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and (2) private mortgage insurance, as defined by Section 2 of the Homeowners Protection Act of 1998 in effect on December 21, 2006. Any prepayments (prepaying qualified mortgage insurance premiums for the entire term of the loan up front) of mortgage insurance provided by the FHA or privately must be capitalized and amortized over the shorter of (1) the life of the loan, or (2) 84 months, beginning with the month the insurance was obtained. Only the amount applicable to the year 2009 is deductible in 2009. Also, no deduction is allowed for any unamortized balance if the mortgage is satisfied before the end of its term.

The deduction is phased-out ratably by 10% for each $1,000 ($500 for married filing separate), or fraction thereof, by which the taxpayer's AGI exceeds $100,000 ($50,000 for married filing separate). Thus, the deduction is unavailable for taxpayers with an AGI exceeding $109,000 ($54,500 for married filing separate).

Example 6D-11 Deducting mortgage insurance premium.

Tim and Jane are married and filing jointly for the tax year 2009. The amount allocable to 2009, for qualified mortgage insurance is $1,500, and their AGI is $104,000. Consequently, they are $4,000 into the $10,000 phase-out range (40%). Their deduction for qualified mortgage insurance must be reduced by 40%, or $600. Therefore, their deduction is $900 ($1,500 less $600).

Passive Activity Interest Expense

A passive activity expenditure is any expenditure considered in determining income or loss from a passive activity under IRC Sec. 469. Passive expenditures include debt proceeds that are traced to a business activity in which the taxpayer does not materially participate. They also include debt proceeds expended to acquire, improve, or refinance rental real estate unless the taxpayer is a real estate professional who materially participates in the rental real estate activity. However, expenditures for nonmaterially participating working interests in oil and gas properties are not treated as passive (unless the working interest activity is held in an activity that limits the taxpayer's liability).

Debt to Acquire Interest in S Corporation or Partnership

As discussed previously, interest on debt to acquire or maintain a partnership interest (including an interest in an LLC treated as a partnership) or S corporation stock is characterized based on the nature of the entity's assets.

Based on IRS Notice 89-35, interest expense generally is treated under the passive loss rules if the business activity of the partnership or S corporation is passive by definition (i.e., rental activities, except for rental real estate activities materially participated in by real estate professionals) or if the taxpayer is treated as not materially participating in the trade or business activities of the partnership or S corporation.

Interest expense properly allocable to partnership or S corporation portfolio income assets is treated as investment interest expense. See discussion later in this lesson for special rules applicable to interest expense allocable to oil and gas working interest properties.

Example 6E-1 Interest expense to invest in a general partnership.

Theodore borrowed $100,000 to invest in a general partnership interest in Qwikbux Partners. He does not materially participate in Qwikbux. Qwikbux invested 50% of all capital contributions in taxable bonds and 50% in a limited partnership that bought rental real estate properties. How does Theodore treat the $12,000 of interest expense on the $100,000 debt to purchase his interest in Qwikbux?

Using the procedures outlined in Notices 89-35 and 88-37, half of the interest expense (allocable to the Qwikbux rental real estate partnership investment) should be treated as a passive item and reported on Form 8582 (assuming Theodore uses the FMV of partnership assets to allocate his debt). The remaining interest expense is treated as investment interest because of the Qwikbux investment in taxable bonds, which are investment assets that produce portfolio income, gains, or losses.

Example 6E-2 Interest expense to purchase a general partnership interest.

Toby borrowed $100,000 to acquire a 10% general partnership interest in Bucks Joint Venture, an active business, from another partner. All of the partnership's assets are used for business, and no debt-financed distributions have been made. Toby does not participate in the partnership's business.

Pursuant to Notice 89-35, Toby reports the interest expense as a passive item on Form 8582 because, while Bucks' activity is not passive by definition, Toby did not materially participate in its business. To the extent the interest is deductible after applying the passive loss rules, it is reported on Schedule E. If Toby had materially participated, he would report the interest expense on Schedule E as nonpassive (trade or business) interest.

The general rule under IRC Sec. 469(h)(2) is that a limited partnership interest is passive by definition. However, Temp. Reg. 1.469-5T(e)(2) provides exceptions. If one or more of these exceptions is met, a limited partner can be treated as materially participating in the partnership trade or business activity.

Example 6E-3 Interest expense to carry a limited partnership interest.

Al owns a 10% limited partnership interest in Bluemax, Ltd., a small aircraft manufacturer. Al does not meet any of the exceptions in Temp. Reg. 1.469-5T(e)(2) to the presumption that his limited partnership interest is passive in nature. Al borrowed $50,000 to make his initial capital contribution to Bluemax and incurred $6,000

of interest expense. All of Bluemax's assets are used in the business, and no debt-financed distributions have been made.

Because Al cannot counter the presumption that his partnership investment is passive, the $6,000 of interest expense is subject to the passive activity rules and reported on Form 8582. To the extent the interest is deductible after applying the passive loss rules, it is reported on Schedule E.

If Al had qualified for one of the exceptions that allow a limited partner to be treated as materially participating in the partnership's activities, he would have reported the interest expense as nonpassive (trade or business) interest on Schedule E.

Incidental Rental of Property and Other Recharacterization Rules

Rental activities (with the exception of rental real estate activities materially participated in by real estate professionals) are, by definition, passive. However, the interest expense to hold the property is treated as investment interest expense rather than as a passive activity item when the rental of property is incidental to the holding of the property for investment reasons if:

1. the principal purpose for holding the property is to realize gain from appreciation, and

2. the gross rental income for the year is less than 2% of the lesser of the property's (a) unadjusted basis or (b) FMV.

Example 6E-4 Interest expense to carry a land investment.

Don, who is not a real estate professional, borrowed $200,000 to invest $250,000 in raw land near a proposed freeway extension. Don is able to rent the land to an adjacent dairy farm for grazing. The rental income is $6,000 per year. Interest expense is $25,000 per year, and annual property taxes are $5,000. At the end of the year, Don estimates that the land has appreciated to $300,000.

In this situation, Don does hold the property solely because of the potential for appreciation, but the rental income ($6,000) exceeds 2% of $250,000 (the lesser of unadjusted basis or FMV). Therefore, the interest expense is part of an overall $24,000 passive loss ($25,000 interest expense and $5,000 of taxes offset by $6,000 rental income) from Don's land rental activity. The loss should be reported on Form 8582, and the deductible portion, if any, should be reported on Don's Schedule E because the loss is from a rental activity.

Variation: If Don's rental income was below the 2% level (i.e., less than $5,000), the interest expense would have been treated as investment interest expense, and the rental income as portfolio (investment) income on Form 4952 (Investment Interest Expense Deduction). The interest (to the extent deductible under the investment interest limitations) and taxes would be reported on Schedule A of Form 1040 as itemized deductions. The income is reported on Schedule E, but not carried to Form 8582 (i.e., is not passive income).

Temp. Reg. 1.469-1T(e)(3)(ii) lists five additional situations where providing property for use by another is not considered a rental activity for the passive activity loss rules. Instead, such activities are generally either investment or trade or business activities.

Where to Report Passive Activity Interest Expense

Passive activity interest expense is first carried to Form 8582 (Passive Activity Loss Limitations) and then to the applicable schedule (i.e., Schedule C, E, or F). It should not be reported as an itemized deduction on Schedule A. (See Examples 6E-1, 6E-2, and 6E-3.)

Oil and Gas Working Interest

A working interest in an oil and gas property that is not held through an entity that limits the taxpayer's liability (i.e., limited partnership, S corporation, or LLC) is treated as a nonpassive activity, regardless of the taxpayer's ability to meet the material participation standard. Interest expense attributable to working interests that are not passive

activities (i.e., not held through a liability-limiting entity) for which the taxpayer does not meet the material participation standard is treated as investment interest expense. The working interest activity is considered property held for investment.

Thus, the interest expense to carry a working interest is reportable on Schedule C (for direct ownership) or Schedule E (if held through a general partnership) and is not subject to the passive loss limitation rules. However, the investment interest expense rules will apply if the taxpayer does not materially participate. If working interests are held through a liability-limiting entity, and the taxpayer does not meet the material participation standard, the applicable interest expense is reported along with other passive items. (See Example 6F-2.)

Example 6E-5 Interest expense to carry working interest in oil and gas property.

John borrowed $150,000 to purchase a leasehold interest and fund the drilling of a well in the Sure Prospect property. John materially participates in the activity. Interest expense on this loan for the year was $6,000.

Interest expense to carry a working interest in an oil and gas property is treated as trade or business interest expense if the taxpayer materially participates in the operation. Since John materially participates in the activity, the interest expense is deductible as a trade or business expense on Schedule C.

Variation: If John did not materially participate in the operation, the interest would still be deducted on Schedule C but the investment interest rules would apply to determine how much of the interest is deductible [i.e., the interest would first be included on Form 4952 (Investment Interest Expense Deduction).] If John held the working interest through a limited partnership, S corporation, or an LLC, the interest would be deducted on Schedule E subject to the passive loss rules.

$25,000 Rental Real Estate Loss Allowance

A taxpayer with AGI of less than $100,000 (calculated before any passive activity losses) qualifies for an exception that allows a deduction of up to $25,000 of losses from rental real estate activities in which the taxpayer actively participates. The exception is phased out for taxpayers with AGI between $100,000 and $150,000. The active participation standard for this rule is less restrictive than the general material participation standard.

Interest expense attributable to rental real estate activities qualifying for this exception is included in the loss from rental real estate and considered part of the passive loss eligible for the $25,000 allowance. The $25,000 limitation is calculated on Form 8582 and ultimately reported on Schedule E. Such interest expense is not subject to the investment interest expense rules.

Example 6E-6 Interest expense to carry rental real estate qualifying for the $25,000 loss allowance under the PAL rules.

Mike owns a rental home in Austin, TX. He manages the property and actively participates in all aspects of its operation. During the current year, it produced a $7,500 loss before any deduction for interest expense. The interest expense on the property was $11,000. Mike is not a real estate professional. He had no other passive activities during the year, and his AGI for the year was $82,000.

Interest expense allocable to rental real estate activities is included in determining the passive loss for the year. Mike's total passive loss from this activity is $18,500 ($7,500 + $11,000). Even though he has no other passive income to offset it, Mike's loss is fully deductible because it is not in excess of $25,000, and his AGI is less than $100,000.

Investment Interest Expense

Interest expense characterized as an investment expense may be limited. Investment interest is deductible only to the extent of net investment income. Any interest expense limited under this rule is carried forward.

General Definition

Investment interest expense is interest allocable to debt proceeds used to acquire property that generates the following types of income or gain:

1. Interest.
2. Dividends.
3. Annuities.
4. Royalties not derived from the ordinary course of a trade or business.
5. Income of these types from an otherwise passive activity (portfolio income).
6. Gain from property producing income of these types.
7. Gain from property held for investment.
8. Oil and gas working interest income treated as nonpassive even though the taxpayer fails to meet the material participation standard.

Investment interest expense does not include interest expense that is capitalized (e.g., under the uniform capitalization rules) or interest expense related to tax-exempt income and not deductible under IRC Sec. 265(a)(2).

Example 6F-1 Interest expense to carry closely held C corporation stock.

Ross borrowed $200,000 to inject additional capital into his 100%-owned C corporation that produces software. Ross is the CEO and meets any applicable material participation standard for the corporation's business activities. Interest expense incurred to carry C corporation stock is investment interest because the debt was incurred to carry property that produces dividend income (stock). Only interest expense to carry investments in pass-through entities can (under the circumstances discussed earlier) be treated as trade or business interest. Therefore, Ross's interest expense on the $200,000 loan is subject to the net investment income limitation.

Net Investment Income

Net investment income is the excess of investment income over investment expenses. Investment income includes (1) gross income from property held for investment (other than qualified dividends), (2) the excess of any net gain over any net capital gain resulting from the disposition of investment property, and (3) as much of the taxpayer's net capital gain from the disposition of investment property and qualified dividends as the taxpayer elects to include. (This election is discussed later in this lesson.) Investment expenses are the deductions allowed (other than interest) that are directly related to the production of investment income. An expense subject to the 2% AGI limitation on miscellaneous itemized deductions is considered only to the extent a deduction is allowed.

For items 2 and 3 in the preceding paragraph, only dispositions of property held for investment are considered (i.e., Section 1231 gains treated as long-term capital gains are not considered), and net gain refers to the net gain from investment assets whether short- or long-term. Capital loss carryovers must be included when computing net gain. Net capital gain refers to the excess of net long-term capital gain over net short-term capital loss. The intent is to exclude net capital gains (i.e., gains taxed at favorable tax rates) and qualified dividends from investment income unless the taxpayer elects to include all or part of these.

Under the principles of IRC Sec. 163(d)(5)(A), property held for investment includes an oil and gas working interest that is treated as nonpassive despite the taxpayer's failure to meet the material participation standard. Thus, the net income or loss from such a working interest (excluding interest expense) is included in computing net investment income. (See Example 6F-2.)

Electing to Include Net Capital Gain and Qualified Dividends in Investment Income

The definition of net investment income excludes net capital gains (i.e., the excess of net long-term capital gains over net short-term capital losses) and qualified dividends unless the taxpayer elects to include all or part of them in investment income. Taxpayers can elect *to include any amount* of net capital gain and/or qualified dividends in investment income. This allows the taxpayer to treat as investment income only the amount of net capital gain or qualified dividend income necessary to maximize the investment interest expense deduction. The election's cost is that the amount of net capital gain and/or qualified dividends included in net investment income becomes ineligible for the favorable rates on net capital gains and qualified dividends. Instead, the elected amount is taxed at the ordinary income rate.

To make the election, the amount of income the taxpayer elects to include in investment income is entered on the appropriate line on Form 4952. The capital gain tax calculation then reduces net capital gains subject to the favorable rates (which includes qualified dividends) by the amounts included in investment income.

The election is available only for net capital gains resulting from the disposition of property held for investment (Section 1231 gains taxed as long-term capital gains are not available for the election) and for qualified dividends [i.e., those subject to the long-term capital gain rate].

Where to Report Deductible Investment Interest Expense

According to the Form 4952 instructions, investment interest generally should be deducted on Schedule A (after using Form 4952 to determine any limitation on the deductibility of investment interest expense). However, investment interest expense attributable to property producing royalty income should be reported on Schedule E. Also, investment interest expense attributable to oil and gas working interests that qualify for the exception to the passive loss material participation standard should be reported on Schedule C (for direct interests) or Schedule E (for pass-through interests). (See Example 6F-2.) Investment interest claimed as an itemized deduction on Schedule A is not subject to the itemized deduction phase-out when 2009 AGI exceeds $166,800 ($83,400 for married filing separately).

Example 6F-2 Interest expense to carry oil and gas partnership investment.

In early 2009, Clay borrowed $100,000 to buy a general partner interest in Dusty Joint Venture—an oil and gas drilling partnership. All of its assets are directly related to its oil and gas working interest activities. Although he is a general partner, Clay does not materially participate in the activity. In 2009, the interest expense on the $100,000 loan was $9,000. Clay's investment in Dusty is not treated as passive because of the special exception for working interests in oil and gas properties.

As discussed earlier, interest expense to carry an investment in an oil and gas working interest that is not a passive activity, and for which the taxpayer does not meet the material participation standards is treated as investment interest. Thus, Clay initially reports his $9,000 of interest expense on Form 4952 to compute the allowable deduction (if any) after the investment interest expense limitation. Clay's income or loss from the partnership is included in the computation of his 2009 net investment income shown on Form 4952. The $9,000 interest expense less the investment interest limitation (if any) from Form 4952 is then entered on Schedule E (because it relates to a partnership).

If Clay had met the material participation standard, he could treat the interest expense as fully deductible business interest on Schedule E (and partnership income or loss would not be considered in net investment income).

Passive Activities Are Not Considered for Investment Interest Purposes

An interest in a passive activity is not treated as held for investment. Thus, interest expense to acquire a passive activity is a passive loss item, not investment interest expense. However, if debt is expended to acquire an interest in a passive activity that also generates portfolio income, the portion of the interest expense from debt allocable to portfolio income assets is treated as investment interest expense rather than as a passive item. (See Example 6E-1.)

Net investment income does not include any income or expenses from passive activities. Note, however, that when rental activities are incidental to an investment activity, the incidental rental activity is not treated as a rental activity under the passive loss rules. Instead, it is considered an investment activity. (See Example 6E-4.) Then, the rental income and expenses are treated as investment income and expenses, and the interest expense is treated as investment interest expense.

Disallowed Investment Interest Expense

Investment interest is allowed as a deduction only to the extent of net investment income. Disallowed investment interest is carried forward indefinitely and treated as investment interest in the carryforward year.

SELF-STUDY QUIZ

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

31. Interest paid on which of the following loans is deductible as an itemized deduction:

    a. Business loans.

    b. Rental loans.

    c. Farm loans.

    d. Home mortgages.

32. When applying interest tracing rules, borrowed funds from several different loans which are deposited at different times into one account are accounted for by assuming:

    a. Earliest loans are expended first.

    b. Latest loans are expended first.

    c. Taxpayer can select which loan is applicable.

    d. No deduction is allowed.

33. In 2009, Susan borrows $50,000 and uses $40,000 of the proceeds to reduce the balance owed on loan A, taken out in 2008. Susan owed $60,000 on loan A and will now owe $20,000 on that loan. The remaining $10,000 of the 2009 loan was used for personal expenditures. The $60,000 owed on loan A had been used as follows: $30,000 for real estate activities and $30,000 for personal expenditures. Using the ordering rules, the $50,000 loan in 2009 is allocated:

    a. $25,000 personal, $25,000 real estate.

    b. $30,000 personal, $20,000 real estate.

    c. $40,000 personal, $10,000 real estate.

    d. $50,000 personal.

34. When debt proceeds are expended for a contribution to the capital of a partnership, the interest expense deduction related to that debt must be allocated based on:

    a. The underlying business assets.

    b. Passive activity assets.

    c. Investment activity assets.

    d. Any reasonable manner as determined by the owner.

35. The uniform capitalization of interest rules apply to:

    a. All real estate.

    b. Depreciable personal property with a life exceeding five years.

    c. Inventory purchased.

    d. Accounts receivable.

36. No deduction is allowed for:

    a. Personal interest.

    b. Business interest.

    c. Passive activity interest.

    d. Qualified residence interest.

37. For a married couple, qualified residence interest expense is deductible up to a maximum of:

    a. $1,000,000 of interest on acquisition indebtedness.

    b. $1,000,000 of acquisition indebtedness.

    c. $1,000,000 of home equity indebtedness.

    d. $1,000,000 of interest on home equity indebtedness.

38. Fred and Susan acquired three homes and use all three as residences; however, Home 1 is their primary residence. Fred and Susan paid the following amounts of home mortgage interest on the homes:

    Home 1: $7,000

    Home 2: $6,000

    Home 3: $5,000

    The maximum amount of mortgage interest Fred and Susan can deduct is limited to:

    a. $7,000.

    b. $12,000.

    c. $13,000.

    d. $18,000.

39. Ray and Norma obtain a home equity loan of $120,000 secured by a qualified residence. The FMV of the home is $400,000, and the balance of the original acquisition indebtedness is $310,000. The amount of interest Ray and Norma may deduct on the $120,000 loan is limited to an indebtedness of:

    a. $90,000.

    b. $100,000.

    c. $120,000.

    d. $400,000.

40. Investment interest expense is deductible, but is limited to net investment. Which of the following is ***not*** considered investment income?

    a. Interest income.

    b. Portfolio income.

    c. Gain from the sale of stock.

    d. Passive activity income.

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.)**

31. Interest paid on which of the following loans is deductible as an itemized deduction: **(Page 183)**

    a. Business loans. [This answer is incorrect. Business loan interest is deductible for AGI on Schedule C.]

    b. Rental loans. [This answer is incorrect. Interest on loans related to rental property is deductible for AGI on Schedule E.]

    c. Farm loans. [This answer is incorrect. Interest on loans related to farming activities is deductible for AGI on Schedule F.]

    d. Home mortgages. [This answer is correct. According to IRS guidance, interest paid on home mortgages is an itemized deduction on Schedule A.]

32. When applying interest tracing rules, borrowed funds from several different loans which are deposited at different times into one account are accounted for by assuming: **(Page 183)**

    a. Earliest loans are expended first. [This answer is correct. Under Temp. Reg. 1.163-8T, in this situation, funds from the earliest loan are presumed to be expended first (FIFO).]

    b. Latest loans are expended first. [This answer is incorrect. Funds from the latest loan may not be presumed to be used first when funds are deposited into an account at different times.]

    c. Taxpayer can select which loan is applicable. [This answer is incorrect. The taxpayer cannot choose which funds are expended first when the loan proceeds are deposited in one account at different times.]

    d. No deduction is allowed. [This answer is incorrect. The deduction is allowed. The treatment depends on the type of loan, and the tracing rules must be followed.]

33. In 2009, Susan borrows $50,000 and uses $40,000 of the proceeds to reduce the balance owed on loan A, taken out in 2008. Susan owed $60,000 on loan A and will now owe $20,000 on that loan. The remaining $10,000 of the 2009 loan was used for personal expenditures. The $60,000 owed on loan A had been used as follows: $30,000 for real estate activities and $30,000 for personal expenditures. Using the ordering rules, how is the $50,000 loan in 2009 allocated? **(Page 183)**

    a. $25,000 personal, $25,000 real estate. [This answer is incorrect. If the repayment ordering rules for multiple-use debt (found in an IRS temporary regulation) are used correctly, the amounts would not be allocated equally to personal expenditures and real estate.]

    b. $30,000 personal, $20,000 real estate. [This answer is incorrect. When multiple use debt is partially repaid, ordering rules from a temporary regulation determine which category is repaid first. Neither Susan's personal expenditures nor her real estate expenditures have been fully paid off if these amounts are used.]

    c. $40,000 personal, $10,000 real estate. [This answer is correct. Under a temporary IRS regulation, when a debt is partially repaid from proceeds of a new loan, personal expenditures from the first loan are deemed to be paid first, then personal expenditures from the second loan are deemed to be paid next.]

    d. $50,000 personal. [This answer is incorrect. For this amount to be correct using the repayment ordering rules for multiple-use debt found in a temporary regulation, the correct amount for Susan's personal expenditures would have to be considered.]

34. When debt proceeds are expended for a contribution to the capital of a partnership, the interest expense deduction related to that debt must be allocated based on: **(Page 188)**

    a. The underlying business assets. [This answer is incorrect. Business assets can be used as the basis, but the interest tracing rules may also be used.]

    b. Passive activity assets. [This answer is incorrect. Passive activities of an entity may be used as the basis if the owner classifies the debt as such, but this in not the only permissable method.]

    c. Investment activity assets. [This answer is incorrect. Investment activities of an entity may be used as the basis if the owner classifies the debt as such, but other allocation methods could be used, as well.]

    d. Any reasonable manner as determined by the owner. [This answer is correct. According to IRS Notice 89-35, debt proceeds expended for a contribution of capital of a pass-through entity (including the purchase of the interest or stock from the entity) are allocated by the owner in any reasonable manner.]

35. The uniform capitalization of interest rules apply to: **(Page 188)**

    a. All real estate. [This answer is correct. The uniform capitalization rules require interest on debt allocable to the production of qualified preperty, such as for all real estate, must be capitalized.]

    b. Depreciable personal property with a life exceeding five years. [This answer is incorrect. The life of qualifed property must exceed 20 years before the uniform capitalization rules apply.]

    c. Inventory purchased. [This answer is incorrect. The uniform capitalization rules apply to the production, not purchase, of qualified property.]

    d. Accounts receivable. [This answer is incorrect. Interest on debt allocable to production property, not accounts receivable, is covered by the uniform capitalization rules.]

36. No deduction is allowed for: **(Page 192)**

    a. Personal interest. [This answer is correct. According to the Code, no deduction is allowed for this type of 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.]

    b. Business interest. [This answer is incorrect. Business interest is deductible for AGI on Schedule C.]

    c. Passive activity interest. [This answer is incorrect. Passive activity interest is deductible, but is subject to certain limitations.]

    d. Qualified residence interest. [This answer is incorrect. Interest on qualified residential mortgages is deductible subject to certain limitations.]

37. For a married couple, qualified residence interest expense is deductible up to a maximum of: **(Page 192)**

    a. $1,000,000 of interest on acquisition indebtedness. [This answer is incorrect. The limit for deductible home mortgage interest is based on the amount of the loan not the amount of interest paid.]

    b. $1,000,000 of acquisition indebtedness. [This answer is correct. According to IRS Regulations, the limit on qualified residential interest paid is $1,000,000 of loan. The limit on home equity loans is $100,000 of indebtedness.]

    c. $1,000,000 of home equity indebtedness. [This answer is incorrect. The limit on the deductibility of interest on a home equity loan is based on $100,000 of indebtedness.]

    d. $1,000,000 of interest on home equity indebtedness. [This answer is incorrect. Home equity loan interest is limited to the interest paid on a maximum of a $100,000 loan.]

38. Fred and Susan acquired three homes and use all three as residences; however, Home 1 is their primary residence. Fred and Susan paid the following amounts of home mortgage interest on the homes: **(Page 192)**

    Home 1: $7,000

    Home 2: $6,000

    Home 3: $5,000

    The maximum amount of mortgage interest Fred and Susan can deduct is limited to:

    a. $7,000. [This answer is incorrect. In the scenario above, the IRS Regulations do not limit Fred and Susan's deduction solely to the amount of interest they paid on their primary residence. The maximum deduction available for Fred and Susan will be greater than the $7,000 of interest they paid on Home 1.]

    b. $12,000. [This answer is incorrect. To get $12,000, Fred and Susan deducted the interest they paid on Home 1 and Home 2. This is a valid deduction based on the rules in the Regulations, but there is a way that Fred and Susan can deduct a larger amount of the interest they paid during the current year.]

    c. $13,000. [This answer is correct. Under the Code, taxpayers may deduct interest paid on their primary home and designate which second home qualifies. To deduct the maximum amount, Fred and Susan designated Home 2 as their second qualified residence because they paid more interest on that home than they did on Home 3 for the year in question.]

    d. $18,000. [This answer is incorrect. Under the Regulations, Fred and Susan are not allowed to deduct the interest they paid on all three homes. The total interest they are allowed to deduct is less than $18,000.]

39. Ray and Norma obtain a home equity loan of $120,000 secured by a qualified residence. The FMV of the home is $400,000, and the balance of the original acquisition indebtedness is $310,000. The amount of interest Ray and Norma may deduct on the $120,000 loan is limited to an indebtedness of: **(Page 192)**

    a. $90,000. [This answer is correct. Under the Code, because the equity in the home is $90,000, the interest paid deduction is limited to the interest on $90,000 of the $120,000 loan. In this scenario, the $100,000 maximum under the code does not come into play.]

    b. $100,000. [This answer is incorrect. A deduction of $100,000 would be considered in the case of home equity indebtedness; however, this is not the amount that Ray and Norma would be allowed to deduct under the Code based on the facts in the scenario.]

    c. $120,000. [This answer is incorrect. The entire amount of the home equity loan is ineligible for the deduction based on the facts in this scenario.]

    d. $400,000. [This answer is incorrect. Though the FMV of Ray and Norma's home is a factor in determining their deduction, the entire amount is not eligible for the deduction.

40. Investment interest expense is deductible, but is limited to net investment. Which of the following is ***not*** considered investment income? **(Page 202)**

    a. Interest income. [This answer is incorrect. Interest income arises from an investment, such as bonds, and is investment income.]

    b. Portfolio income. [This answer is incorrect. Portfolio income arises from investments in stocks and bonds and similar investments.]

    c. Gain from the sale of stock. [This answer is incorrect. The gain from the sale of an investment is considered investment income.]

    d. Passive activity income. [This answer is correct. Passive activity requires netting passive income with passive expenses. According to the Internal Revenue Code, investment income does not include passive activities.]

EXAMINATION FOR CPE CREDIT

Lesson 6 (TDBTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

31. The definition of passive activity *always* includes which of the following?

    a. Rental real estate.

    b. Working interest in oil and gas.

    c. An S Corporation interest.

    d. Activities in which the taxpayer does not materially participate.

32. If a residence is rented for part of the year, it can only be treated as a qualified residence if the taxpayer uses it for personal purposes that exceed the greater of _____or 10% of the number of days the unit was rented at a fair rental rate:

    a. 14 days.

    b. 30 days.

    c. 183 days.

    d. 365 days.

33. When borrowed funds from several debts incurred together are simultaneously deposited into an account, what method does the taxpayer use to determine the order the funds are deposited?

    a. FIFO.

    b. LIFO.

    c. Taxpayer can select the order.

    d. The 90-day rule is followed.

34. Proceeds from a single debt are allocated to several different categories when such debt is partially repaid. Under the ordering rules, the category that is deemed to be repaid first is:

    a. Personal expenditures.

    b. Active participation rental real estate expenditures.

    c. Former passive activity expenditures.

    d. Investment expenditures.

35. Interest paid on which of the following indebtedness is deductible as an itemized deduction?

    a. Interest on a tax deficiency.

    b. Points paid in a traditional refinancing.

    c. Passive activities.

    d. Investment interest.

36. Iris and John have mortgages on the following properties:

Principal residence	$ 250,000
Motor home, used as residence	$ 180,000
Land, used for their company	$ 500,000
Rent house	$ 200,000

    Iris and John may deduct interest as an itemized deduction on what amount of mortgage?

    a. $250,000.

    b. $430,000.

    c. $450,000.

    d. $750,000.

37. Bruce and Sally obtained a $130,000 home equity loan secured by a qualified residence. The proceeds were used for a two-year trip around the world. The FMV of the residence was $300,000 and the acquisition indebtedness was $150,000. Bruce and Sally may deduct home mortgage on *total* indebtedness of:

    a. $65,000.

    b. $150,000.

    c. $250,000.

    d. $280,000.

38. In 2009, Patty borrowed $300,000 using her home as collateral. Patty paid $6,000 in points to obtain a more favorable interest rate. She used $120,000 on improvements to her residence and the remaining $180,000 was used to pay off her existing mortgage on her home. Patty may deduct points of:

    a. None.

    b. $2,400.

    c. $3,600.

    d. $6,000.

39. Sharon owns a rent house and actively participates in its operation. For the year, she had a $6,000 net loss, not including $5,000 of interest expense paid on a loan to purchase the rent house. Sharon's AGI is $80,000. From this activity, Sharon can deduct a rental loss of:

    a. $5,000.

    b. $6,000.

    c. $11,000.

    d. $25,000.

40. Interest expense incurred in a passive activity is deducted to arrive at net:

    a. Passive income.

    b. Business income.

    c. Investment income.

    d. Portfolio income.

GLOSSARY

2% AGI Limitation: Some miscellaneous itemized deductions are subject to a 2% of AGI floor. Examples include the following: IRA losses, employment search costs, investment advice, and management fees.

30% Charity: Two different 30% limitations apply to two different types of contributions. The first limitation (referred to as the "regular" 30% limitation) applies to gifts of property (including cash) other than capital gain property to charities that do not qualify as 50% charities. Common charities in this group include veterans organizations, domestic fraternal societies, nonprofit cemeteries, and certain private foundations.

50% Charity: The first 50% limitation provides that aggregate deductible contributions (including those subject to the separate 20% or 30% limitations) cannot exceed 50% of AGI. The second 50% limitation refers to gifts (other than capital gain property) to certain types of charitable organizations ("50% charities") that are considered first in computing the overall 50% limit. The most common 50% charities include churches, schools, hospitals, governmental entities, private operating foundations, and other nonprofit agencies organized for charitable, religious, educational, scientific, or literary purposes.

Activities of Daily Living (ADLs): ADLs include eating, toileting, transferring, bathing, dressing, and continence. The inability to perform at least two ADLs without substantial assistance for at least 90 days due to a loss of functional capacity is one determination of a chronically ill individual.

Additional Standard Deduction: 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.

Cash Contribution: Donors must get a written acknowledgment from the charity if the value of the charitable contribution (in cash or other property) is $250 or more—a canceled check or other reliable records are not sufficient proof.

Dependent: A dependency exemption deduction is available for each person who is a dependent of the taxpayer for the year. There are some special rules to define a dependent: (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 can not be a dependent of another taxpayer in that same year, and (3) a dependent must be a U.S. citizen or national, or a resident of the United States, Canada, or Mexico.

Filing Status: There are five filing status possibilities for individuals:

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

Gambling Losses: Gambling losses are deductible to the extent of gambling income, but only as a Schedule A miscellaneous itemized deduction.

Home Equity Loan: The only restrictions on home equity indebtedness are the $100,000 (or FMV) cap and the requirement that the debt be secured by a qualified residence.

Itemized Deductions: Deductions that are itemized on IRS Form 1040 Schedule A such as medical expenses, casualty losses, and miscellaneous itemized deductions. Taxpayers can deduct the larger of itemized deductions or the standard deduction.

Job Search Expenses: Expenses incurred by the taxpayer when searching for new employment in the same trade or business are deductible.

Medical Expenses: Qualified medical expenses generally include any unreimbursed costs (of the individual or of the individual's spouse or dependent) that are eligible for the medical expenses itemized deduction. Some qualified medical expenses include: Dental fees, glasses, hospital services, and smoking-cessation programs.

Mortgage Interest: The interest expense deductible on Schedule A as qualified residence interest.

Passive Activity: A passive activity is generally (1) any rental activity (except those of certain real estate professionals) or (2) a business activity in which the taxpayer does not materially participate.

Personal Casualty Loss: The Internal Revenue Code allows a deduction for losses resulting from a casualty or theft of personal-use property. A casualty is the damage, destruction, or loss of property resulting from sudden, unexpected, or unusual identifiable events. The amount of the loss generally is the lesser of the adjusted basis of the property or the decrease in fair market value due to the casualty or theft. Adjusted basis is determined when the casualty occurs. The losses are also subject to the $100 ($500 for 2009) and 10% of AGI reductions.

Personal Deduction: Taxpayers who do not itemize their deductions generally are entitled to a standard deduction to reduce adjusted gross income in arriving at taxable income.

Qualified Vehicle: Claimed charitable deductions exceeding $500 for donations of motor vehicles, boats and airplanes (qualified vehicles). For charitable contributions of qualified vehicles made after December 31, 2004, the amount of the deduction depends on how the charity uses the vehicle.

Qualifying Long-Term Care Services: Such services are defined as necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services (as well as maintenance or personal care services) that are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

Rental Activity: Rental activities (with the exception of rental real estate activities materially participated in by real estate professionals) are, by definition, passive. However, the interest expense to hold the property is treated as investment interest expense rather than as a passive activity item when the rental of property is incidental to the holding of the property for investment reasons.

Standard Deduction: Taxpayers who do not itemize their deductions generally are entitled to a standard deduction to reduce adjusted gross income in arriving at taxable income

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COMPANION TO PPC'S 1040 DESKBOOK

COURSE 3

Securities Transactions and Debt Transactions (TDBTG093)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to commonly encountered securities and debt transactions. The first lesson covers topics that pertain to reporting gain or loss on the sale of stock. The second lesson covers the rules for deducting bad debt losses and explains the tax treatment of debt discharge income and foreclosures.

PUBLICATION/REVISION DATE: November 2009

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC 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 course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2010**

KNOWLEDGE LEVEL: Basic

LEARNING OBJECTIVES:

Lesson 1—Securities Transactions

Completion of this lesson will enable you to:

- Determine stock holding periods and capital gain tax rates.
- Determine the tax reporting requirements for mutual fund income and sales.
- Identify the tax rules for option writers, option holders, and Section 1256 contracts.
- Identify important aspects of short sales, wash sales, constructive sales, Section 1244 stock, qualified small business stock (QSBS), worthless securities, and employee stock options and make relevant calculations.
- Distinguish between a stock trader and an investor.

Lesson 2—Bad Debt Losses, Debt Discharge Income, and Foreclosures

Completion of this lesson will enable you to:

- Differentiate between business and nonbusiness bad debts.
- Identify the rules of debt discharge income for a solvent taxpayer and an insolvent taxpayer and make relevant calculations.
- Identify the tax rules for foreclosures involving recourse, nonrecourse, and seller-financed debt.

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Lesson 1: Securities Transactions

Introduction

This lesson covers commonly encountered security transactions. Unless held by a dealer, securities are generally capital assets subject to the capital gain provisions. However, the gains and losses of a securities trader who makes the mark-to-market election under Section 475(f) are ordinary rather than capital.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:

- Determine stock holding periods and capital gain tax rates.
- Determine the tax reporting requirements for mutual fund income and sales.
- Identify the tax rules for option writers, option holders, and Section 1256 contracts.
- Identify important aspects of short sales, wash sales, constructive sales, Section 1244 stock, qualified small business stock (QSBS) worthless securities, and employee stock options and make relevant calculations.
- Distinguish between a stock trader and an investor.

Capital Gain Rates and Stock Holding Periods

Stock Holding Periods

A nondealer's sale of stock results in long- or short-term capital gain or loss depending on the stock's holding period. Stock sales receive long-term treatment whenever the holding period exceeds one year.

A stock's holding period generally begins on the day following the day of acquisition and ends on (and includes) the day of disposition. For securities traded on an established securities market, the holding period begins on the day after the *trade date* and ends on the date of disposition (i.e., the trade date). The *settlement date* is ignored. Thus, the taxpayer's overall method of accounting does not affect when the transaction is reported, and gain or loss must be reported in the tax year the disposition (i.e., trade date) falls.

Stock can be acquired other than by purchase, which can impact how the holding period is determined. These include the following:

1. *Stock Dividends.* If the stock dividend is nontaxable, the taxpayer's holding period for the new stock is the same as for the old shares upon which the dividend was based. If the stock dividend is taxable, the holding period of the new shares begins on the date of distribution.

2. *Dividend Reinvestment Plans.* Where a shareholder buys stock under a dividend reinvestment plan, either with the company or through a company-arranged open market transaction, the participating shareholder's holding period begins on the date following the day on which the shares are credited to the participant's account.

3. *Stock Splits.* The holding period for stock received in a stock split is the same as for the old shares upon which the stock split was based.

4. *Stock Received as a Gift.* When a taxpayer receives a gift of stock and his basis is determined with reference to the donor's, his holding period includes that of the donor. However, if the donee's basis in the gifted stock is fair market value (FMV) at the date of gift (i.e., when gifted property is sold at a loss and the donor's basis in the stock exceeded its FMV at the time of the gift), the donee's holding period begins on the day after the date of the gift.

5. *Inherited Stock.* Property inherited from a decedent is automatically deemed to be held more than one year. Therefore, the sale or exchange of inherited stock will result in long-term treatment regardless of how long the heir actually holds it. In reporting a sale, the word "INHERITED" should be written in column (b) on Schedule D instead of the date the property was received.

6. *Stock Acquired by Exercising a Stock Option.* The holding period of stock acquired by the exercise of a stock option begins on the date after the option is exercised.

7. *Tax-free Stock Exchange.* If stock is received in a tax-free exchange, the holding period of the old stock tacks on to that of the new stock.

8. *Employer Stock Received from an Employer's Retirement Plan.* If a taxpayer receives employer stock in a distribution from its retirement plan, his holding period in the stock usually begins on the day after the day the plan trustee delivers the stock to the transfer agent with instructions to reissue it in the taxpayer's name. To the extent the distributed stock includes net unrealized appreciation (NUA), gain from a subsequent sale may automatically receive long-term treatment to the extent of such NUA.

Identifying Shares Sold. Taxpayers often acquire stock in a company at different dates and at different prices. When less than the entire holding of stock is sold, identifying which shares were sold not only affects the amount of gain or loss but also whether the sale is long- or short-term. The two methods for identifying shares of stock sold when taxpayers sell less than their entire holdings in a particular stock are (1) the first-in, first-out (FIFO) method and (2) the specific identification method.

FIFO is used when a taxpayer does not or cannot specifically identify which shares of stock are sold. This method assumes the shares acquired first are sold first. See Example 1B-2 for a FIFO basis computation.

If the taxpayer specifically identifies the shares sold, the basis and holding period of those shares are used in computing the character and amount of gain or loss. Adequate identification is made when the taxpayer delivers the specific shares to be sold to the broker selling the stock. If the stock is held by the taxpayer's broker in street name (1) the taxpayer must, at the time of sale, specify to the broker which shares are to be sold; and (2) the broker must, within a reasonable time after the sale, confirm this specification to the taxpayer in a written document. The identified stock is then deemed to be sold even if the broker actually delivers to the buyer shares from another lot of stock.

Capital Gain Tax Rates

A *capital asset* is any property except:

1. inventory;

2. depreciable or real property used in the taxpayer's trade or business, but IRC Sec. 1231 allows capital gain treatment on such items;

3. specified literary or artistic property;

4. business accounts or notes receivable; or

5. certain U.S. publications.

Thus, securities generally are capital assets unless held by a dealer. Gains and losses from the sale of securities by a dealer produce ordinary income and losses rather than capital gains. (Reg. 1.471-5 defines a dealer as a merchant of securities with an established place of business who is regularly engaged in the purchase of securities and their resale to customers. As a practical matter, few individuals meet this definition.)

Securities sold by a trader receive capital gain or loss treatment [unless the trader has made the mark-to-market election under Section 475(f)], and the trader's expenses, including subscriptions to financial periodicals, telecommunication and clerical expenses, and depreciation on data processing equipment and related software, etc., are deducted in arriving at adjusted gross income rather than as itemized deductions.

The applicable capital gain tax rate depends not only on how long property is held but also the type of property sold. A 15% long-term rate generally applies if the property is held more than 12 months while a short-term rate (i.e., generally ordinary income rate) applies when the property is held one year or less. However, see discussion below

for reduced capital gain rates when the gain, absent a preferential rate, would be taxed at the 10% or 15% ordinary income rates. Also, special rules and rates apply to the sale of collectibles, qualified small business stock, and unrecaptured Section 1250 gain.

The long-term capital gain rate for taxpayers in the 10% or 15% ordinary tax bracket is generally 0% (rather than 15%). However, to the extent long-term capital gain causes the taxpayer's taxable income to exceed the upper threshold of the 15% ordinary income tax bracket, the capital gain is taxed at 15%. Thus, taxpayers can have long-term capital gain taxed at two different rates.

Example 1A-1 Capital gain rate reduced for taxpayers in the lower tax brackets.

Nancy is single and has taxable income of $60,000 for 2009. Included in this amount is $42,000 of gain from the November 3, 2009, sale of stock she purchased in 2005.

The 2009 25% rate for a taxpayer using the single filing status begins at $33,950. Thus $15,950 ($33,950 − $18,000 of ordinary income) of Nancy's long-term capital gain would otherwise be taxed at 15%. As a result, this amount is taxed at 0%; the remaining $26,050 ($42,000 − $15,950) of capital gain is taxed at 15%. Nancy's 2009 tax is computed as follows:

Ordinary income	
$8,350 × 10%	$ 835
$9,650 × 15%	1,448
Long-term capital gain:	
$15,950 taxed at 0%	—
$26,050 taxed at 15%	3,907
Total tax	$ 6,190

Adjusted Net Capital Gain. The 15% and 0% capital gain tax rates apply to adjusted net capital gain. Qualifying dividends are taxed at the same rate as long-term capital gains. This is accomplished by adding qualified dividend income to the net capital gain to arrive at adjusted net capital gain. However, to prevent dividends from being offset by capital losses, adjusted net capital gain is computed by first reducing (but not below zero) net capital gain (i.e., net long-term gain) by (1) capital gain attributable to Section 1250 property and (2) 28% rate capital gains. Add qualified dividends amount to this to arrive at adjusted net capital gain.

Capital gain attributable to Section 1250 property is the gain on a sale of Section 1250 property to the extent depreciation adjustments on the property exceed those subject to ordinary income recapture. 28% rate capital gains are the sum of collectible gains (gains from assets such as art, rugs, antiques etc. that are capital assets in the taxpayer's hands and held for over a year) and Section 1202 gain from the sale of certain small business stock reduced (but not below zero) by losses from collectibles, net short-term capital losses, and long-term capital loss carryovers.

Gains and Losses from Pass-through Entities. When capital gains and losses are recognized in pass-through entities, the determination of when they are taken into account is made at the entity level. Pass-through entities include regulated investment companies (i.e., mutual funds), real estate investment trusts (REITs), S corporations, partnerships, estates, trusts, common trust funds, certain foreign investment companies, and Section 1295 qualified electing funds. These pass-through entities must determine and disclose to owners the proper category of capital gains and losses.

Alternative Minimum Tax. The maximum capital gain rates also apply to AMT.

Capital Losses

Taxpayers offset capital gains with capital losses, and to the extent there are excess capital losses, up to $3,000 ($1,500 for married filing separate returns) can be deducted against ordinary income. Remaining capital losses can be carried forward indefinitely, retaining their character as either short- or long-term. However, losses not used in a decedent's final return expire unused.

A taxpayer's capital loss carryover is the amount that his total net capital loss for the year exceeds the lesser of (1) his allowable capital loss deduction for the year or (2) his adjusted taxable income for the year. "Adjusted taxable income" is taxable income increased by the allowable capital loss deduction for the year and the deduction for personal exemptions. For many taxpayers, this method of determining the carryover effectively allows them to convert all or part of a net capital loss deduction to a carryover when they receive no tax benefit from the deduction (e.g., they have negative taxable income for the year); however, this will not always be the case if the taxpayer would have positive taxable income without the deductions for personal exemptions and allowable capital losses.

Example 1A-2 Computing a capital loss carryover.

Al and Ann file a joint return for 2009. For 2009, they incur a $5,000 net capital loss. What is their capital loss carryover to 2010 based on the following three income scenarios?

	Scenario 1	Scenario 2	Scenario 3
Wages	$ 47,500	$ 47,500	$ 47,500
Business loss	—	(34,000)	(50,000)
Capital loss deduction	(3,000)	(3,000)	(3,000)
Standard deduction	(11,400)	(11,400)	(11,400)
Personal exemption deduction	(7,300)	(7,300)	(7,300)
Taxable income	$ 25,800	$ (8,200)	$ (24,200)
Adjusted taxable income	$ 36,100	$ 2,100	$ (13,900)
Capital loss used in 2009	3,000	2,100	—
Capital loss carryover to 2010	2,000	2,900	5,000

In Scenario 1, the capital loss carryover is computed using the $3,000 capital loss deduction allowed in 2009, since that amount is less than adjusted taxable income. In Scenarios 2 and 3, however, adjusted taxable income is less than the $3,000 allowable capital loss deduction for 2009 so the capital loss carryover is computed using the adjusted taxable income amount (but not less than zero).

When a taxpayer has capital gains and losses that are subject to different capital gain rates, the capital gains and losses are first divided into short- and long-term groups, with the long-term group further divided by capital gain tax rates [15% (or 0%), 25%, and 28%]. A net loss in a long-term group first offsets gains in the highest long-term rate group before being applied to gains in the next highest long-term rate group. For example, a net long-term loss in the 15% group offsets a net gain in the 28% group before offsetting net gain in the 25% group. If there is an overall net long-term loss, it offsets net short-term gain. If there is a net short-term capital loss, it first offsets net gain from the 28% long-term group before applying to net gains from the 25% and 15% groups.

A long-term capital loss carryover offsets long-term capital gains first, beginning with the highest (28%) long-term capital gain tax rate group. A short-term capital loss carryover offsets net short-term gain first; any remaining carryover offsets long-term gains, beginning with the highest long-term capital gain tax rate group.

Example 1A-3 Offsetting capital gains and losses.

For 2009, John has the following capital gains and losses (grouped by the applicable capital gains tax rate):

Category	Amount	Applicable Tax Rate Group
Unrecaptured Section 1250 gain	$ 4,000	25%
Net short-term loss	(3,000)	35%
Net collectibles gain	6,000	28%
Net long-term loss	(2,000)	15%

Using the ordering rules, the $2,000 long-term loss (15% group) first offsets the $6,000 collectibles gain (28% group, leaving a $4,000 collectibles gain, which is then offset by the $3,000 short-term capital loss. Thus, John has a $1,000 collectibles gain (subject to 28% tax) and a $4,000 unrecaptured Section 1250 gain (subject to 25% tax).

SELF-STUDY QUIZ

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

1. The holding period for stock traded on an established securities market begins and ends on which of the following?

   a. Begins on the day after the trade date of the acquisition and ends on the trade date of the disposition.

   b. Begins on the day after the trade date of the acquisition and ends on the settlement date of the disposition.

   c. Begins on the day of the acquisition and ends on the day of disposition.

   d. Begins on the day the cash is paid for the acquisition and ends on the day the cash is received from the disposition.

2. Of the following, which two methods may be used to identify the basis and holding periods of shares of stock sold when the taxpayer does not sell all of a particular stock?

   a. The specific identification method and the low-basis method.

   b. The specific identification method and the high-basis method.

   c. The first-in, first-out (FIFO) method and the last-in first-out (LIFO) method.

   d. The first-in, first-out (FIFO) method and the specification identification method.

3. Sue purchased 100 shares of MG stock on January 2, 2009. The value of the MG stock rises dramatically during the year. Sue decides that she should sell all of the MG stock to take advantage of the increase in value. What is the earliest date that she can dispose of the MG stock and receive long-term capital gain treatment?

   a. January 2, 2010.

   b. January 3, 2010.

   c. July 3, 2009.

   d. December 31, 2009.

4. Tom and Betty have a $4,000 capital loss for 2009. On their 2009 joint tax return, they report the following information: wages of $50,900; business loss of $39,000; standard deduction of $11,400; and personal exemptions of $7,300. What is their capital loss carryover to 2010?

   a. $4,000.

   b. $3,500.

   c. $500.

   d. $0.

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.)**

1. The holding period for stock traded on an established securities market begins and ends on which of the following? **(Page 225)**

   a. Begins on the day after the trade date of the acquisition and ends on the trade date of the disposition. [This answer is correct. Under the IRS Revenue Rules, this accurately describes the holding period for the type of stock. In addition, the taxpayer's overall method of accounting does not affect when the transaction is reported.]

   b. Begins on the day after the trade date of the acquisition and ends on the settlement date of the disposition. [This answer is incorrect. The settlement date is ignored for this type of stock, according to the Revenue Rules.]

   c. Begins on the day of the acquisition and ends on the day of disposition. [This answer is incorrect. According to the Revenue Rules, the taxpayer excludes the day of acquisition when calculating the holding period.]

   d. Begins on the day the cash is paid for the acquisition and ends on the day the cash is received from the disposition. [This answer is incorrect. The taxpayer's overall method of accounting does not affect when the transaction is reported.]

2. Of the following, which two methods may be used to identify the basis and holding periods of shares of stock sold when the taxpayer does not sell all of a particular stock? **(Page 225)**

   a. The specific identification method and the low-basis method. [This answer is incorrect. The taxpayer may not arbitrarily select the shares with the lowest basis to manipulate the gain or loss.]

   b. The specific identification method and the high-basis method. [This answer is incorrect. The taxpayer may not arbitrarily select the shares with the highest basis to manipulate the gain or loss.]

   c. The first-in, first-out (FIFO) method and the last-in first-out (LIFO) method. [This answer is incorrect. The LIFO method is not one of the methods listed in the regulations.]

   d. The first-in, first-out (FIFO) method and the specification identification method. [This answer is correct. Under the IRS regulations, the taxpayer can specifically identify the shares sold, the basis and holding period of that stock is used in determining the character and amount of the gain or loss. The FIFO method is used when the taxpayer cannot specifically identify the shares sold.]

3. Sue purchased 100 shares of MG stock on January 2, 2009. The value of the MG stock rises dramatically during the year. Sue decides that she should sell all of the MG stock to take advantage of the increase in value. What is the earliest date that she can dispose of the MG stock and receive long-term capital gain treatment? **(Page 225)**

   a. January 2, 2010. [This answer is incorrect. The holding period of the MG stock as of January 2, 2010, would qualify the transaction for the short-term rate, as that rate is described in the Code.]

   b. January 3, 2010. [This answer is correct. Under the Internal Revenue Code, long-term capital gain tax rates generally apply if the stock is held for more than 12 months. Since the holding period begins the day after the acquisition, stock must be held one year and a day from the date of acquisition to receive long-term capital gain treatment.]

   c. July 3, 2009. [This answer is incorrect. According to the Code, if Sue sells the stock on July 3, 2009, the transaction will qualify for the short-term rate, which is generally ordinary income rate.]

d. December 31, 2009. [This answer is incorrect. Holding the stock until the end of the calendar year in which it was purchased does not necessarily qualify the transaction for the long-term rate under the Code. In this scenario, if Sue sells the stock on December 31, 2009, the transaction will qualify for the short-term rate.]

4. Tom and Betty have a $4,000 capital loss for 2009. On their 2009 joint tax return, they report the following information: wages of $50,900; business loss of $39,000; standard deduction of $11,400; and personal exemptions of $7,300. What is their capital loss carryover to 2010? **(Page 225)**

a. $3,500. [This answer is incorrect. This is the total amount of Tom and Betty's capital loss for 2009. They cannot carry forward the whole capital loss to 2010. Calculations must be performed to determine the correct carryover amount.]

b. $3,500. [This answer is correct. Under the Code, a taxpayer's capital loss carryover is the excess of the net capital loss over the lesser of the net capital loss deduction for the year or the adjusted taxable income. Adjusted taxable income is taxable income o increased by the allowable capital loss deduction for the year and the deduction for personal exemptions. In this case, the tax loss is $9,800 ($50,900 − $39,000 − $3,000 − $11,400 − $7,300). The adjusted taxable income is $500 ($ − 9,800 + $3,000 + $7,300). The capital loss carryover is $3,500 ($4,000 − $500).]

c. $500. [This answer is incorrect. This is the amount of Tom and Betty's adjusted taxable income in 2009. Further calculations are needed, however, to determine how this amount affects their capital loss carryover for 2010.]

d. $0. [This answer is incorrect. If the calculations are performed correctly, Tom and Betty will have an amount of capital loss to carryover to 2010 that is greater than zero.]

Reporting Income and Sales from Mutual Funds

Reporting Shareholder Income

Capital gain or loss is recognized when an individual sells, exchanges, or redeems mutual fund shares. This includes an exchange of shares in one fund for shares in a different fund, even if the funds are in the same mutual fund family. The amount of gain or loss is the difference between the adjusted basis in the shares and the selling price (less any costs associated with the sale, exchange, or redemption) and is reported on Schedule D.

Distributed and Reinvested Income. Mutual fund income reported to shareholders on Form 1099-DIV is taxable to shareholders whether the income and gains are distributed, reinvested in additional fund shares, or retained by the fund itself. In addition, distributions declared and payable to mutual fund shareholders of record as of calendar year-end and paid by January 31 of the following year are taxable in the year declared. Thus, the Form 1099-DIV amount and actual distributions a shareholder receives during the year may differ.

Retained Capital Gains. In some cases, a mutual fund will retain (rather than distribute to shareholders) realized long-term gains. The fund must pay a fund-level income tax on retained gains and send a Form 2439 (Notice to Shareholder of Undistributed Long-Term Capital Gains) to each shareholder. Form 2439 reports each shareholder's portion of the retained gains and fund-level income tax paid on those gains. Each shareholder reports his share of the retained gain on Part II of Schedule D and claims a credit (on line 70 of Form 1040) for his share of income tax paid by the fund. In addition, box a of line 70 should be checked, and Copy B of Form 2439 must be attached to the shareholder's return. The shareholder's basis in fund shares is increased by the gain and reduced by the share of fund-level income tax reported on Form 2439.

Tax-exempt Income. Mutual fund income from tax-exempt interest is reported to shareholders in box 8 of Form 1099-INT. The shareholder should include these exempt interest amounts on the tax-exempt interest line on page 1 of Form 1040, along with other exempt interest income. Some or all of the tax-exempt interest may be an alternative minimum tax (AMT) preference item. The tax-exempt income is also used in computing the taxability of social security benefits and may result in some of the taxpayer's expenses associated with carrying the mutual fund shares being disallowed.

Return of Capital (Nontaxable) Distributions. A distribution that is not out of earnings and profits is a return of the shareholder's investment, or capital, in the mutual fund and is shown in box 3 of Form 1099-DIV. These return of capital distributions are generally not taxed; however, they do reduce the shareholder's basis in the shares. If a distribution exceeds the shareholder's basis in the funds, the excess is a taxable capital gain reportable on Schedule D (whether it is a short- or long-term gain depends on how long the shares were held).

Determining Basis in Mutual Fund Shares

Investors in mutual funds may reinvest dividends and capital gains so they have current income without actually receiving any distributions or, in some cases, a fund may retain realized capital gains. In these situations, special calculations are necessary to determine the tax basis of the mutual fund shares.

When mutual fund shares are sold, exchanged, or redeemed, their basis must be determined. The shares' original cost is the starting point. It is increased for the following items:

1. Reinvested dividends (included in income reported on Form 1099-DIV).
2. Reinvested capital gains (included in income reported on Form 1099-DIV).
3. Undistributed long-term capital gains (reported as income on Form 2439).
4. Reinvested tax-exempt dividends (reported on information statements issued by the fund).

The following reduce basis:

1. Distributions consisting of return of capital (reported as nontaxable distributions on Form 1099-DIV).

2. Fund-level income tax paid on retained long-term capital gains (reported on Form 2439).

A special rule applies to mutual fund load charges if (1) the load charges are incurred in a transaction in which the taxpayer acquires fund shares and a reinvestment right, (2) such shares are disposed of within 90 days, and (3) the taxpayer subsequently buys other mutual fund shares with a reduced load charge due to the reinvestment right. To the extent the load charge is reduced in the second transaction, the taxpayer cannot consider the original load charge in determining gain or loss in the disposition of the original mutual fund shares (it is considered in the second transaction instead). A reinvestment right is the right to acquire stock in a mutual fund without paying a load charge or with the payment of a reduced charge. This rule prevents taxpayers from taking a quick loss equal to the load charge on the original shares simply by switching to another fund in the same family.

Example 1B-1 Calculating basis when income is reinvested.

John purchased 100 shares of Blue Sky Growth Fund, a mutual fund, for $2,000 on February 1, 2007. He incurred a load charge of $100. His beginning cost basis in the mutual fund is $2,100, or $21 per share. In January 2008, he received a 2007 Form 1099-DIV reflecting a $150 dividend, which John reinvested in Blue Sky. In January 2009, John received a 2008 Form 1099-DIV reflecting a $300 long-term capital gain and a $100 dividend, both of which were reinvested in the fund. John sold all of his shares on August 3, 2009, for $3,100. John's basis in Blue Sky is determined as follows:

Original cost (including commissions)	$ 2,100
2007 dividend (reinvested in Blue Sky)	150
2008 capital gain (reinvested in Blue Sky)	300
2008 dividend (reinvested in Blue Sky)	100
Total tax basis	$ 2,650

Therefore, John reports a capital gain of $450 ($3,100 − $2,650) on his 2009 return. The gain associated with the shares acquired (from the reinvested income) on or after August 3, 2008, is short-term; the remainder of the gain is long-term.

If fund shares are bought at different times, the basis of shares sold must be determined by using an ordering procedure. The three methods for determining the basis of mutual fund shares are (1) first-in, first-out (FIFO); (2) the specific identification method; and (3) the average basis method.

FIFO Method. FIFO is used if the taxpayer does not elect an average basis method or does not use the specific identification method.

Example 1B-2 FIFO basis computation.

Bob purchased 100 shares of the INV Fund, a mutual fund, for $10 per share on February 1, 2008. On March 3, 2008, a $55 dividend was declared. Since Bob had designated that all dividends be reinvested, this $55 dividend purchased five additional shares. On February 2, 2009, he purchased an additional 100 shares for $12 per share. On July 2, 2009, Bob sold 125 shares for $15 per share. To compute Bob's basis in the shares sold, his transactions are summarized as follows:

Transactions	No. of Shares	Total Basis	Per Share Basis
2/1/08—original purchase	100	$ 1,000	$ 10
3/3/08—dividend reinvestment	5	55	11
2/2/09—second purchase	100	1,200	12
Total basis		$ 2,255	

Transactions	No. of Shares	Total Basis	Per Share Basis
FIFO basis of 125 shares sold:			
100 shares bought 2/1/08 (100 × $10)		$ 1,000	
5 shares bought 3/3/08 (5 × $11)		55	
20 shares bought 2/2/09 (20 × $12)		240	
Total FIFO basis of 125 shares sold		$ 1,295	

Bob has 80 shares remaining from his February 2, 2009 lot. These shares have basis of $12 each. On his 2009 return, Bob will have a long-term gain of $520 ($1,575 proceeds − $1,055 basis) on the 105 shares acquired in 2008 and a short-term gain of $60 ($300 proceeds − $240 basis) on the 20 shares acquired on February 2, 2009.

Specific Identification Method. Specific identification allows a taxpayer to sell shares he bought in a particular transaction. Since mutual fund shares are held by the fund or the fund's agent in book entry form, the question arises whether the specific identification requirements of Reg. 1.1012-1(c) apply. The Tax Court has stated they do. Thus, when a taxpayer places a sell order, he must identify the specific shares that he wants to redeem and must receive confirmation of the same.

Average Basis Method. Average basis can be used if the shares are in an account handled by a custodian or agent who acquires or redeems shares. Under Reg. 1.1012-1(e), average basis is figured using either the double-category or single-category methods, as explained later. A taxpayer electing to use an average basis method should attach an election statement to his return for the first year the election is effective, indicating which method (single-category or double-category) is being used. The taxpayer must disclose that the method is used each year a sale occurs. According to the Schedule D instructions, a taxpayer using an average basis should include "AVGB" in column (a) of Schedule D. Once a method is elected, it must be used for all shares held in the same mutual fund until revoked, which requires permission from the IRS.

SELF-STUDY QUIZ

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

5. In calculating the tax basis of mutual fund shares, the original cost of the shares is increased by certain items. Which of the following does **not** increase the basis of the shares?

   a. Reinvested capital gains.

   b. Reinvested taxable and tax-exempt dividends.

   c. Undistributed long-term capital gains.

   d. Nontaxable distributions of return of capital.

6. There are three allowable methods for determining the basis of mutual fund shares sold when the shares are acquired at different times. Which of the following methods is **not** an allowable method?

   a. Specific identification method.

   b. First-in, first-out (FIFO) method.

   c. Last-in, first-out (LIFO) method.

   d. Average basis method.

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.)**

5. In calculating the tax basis of mutual fund shares, the original cost of the shares is increased by certain items. Which of the following does **not** increase the basis of the shares? **(Page 232)**

   a. Reinvested capital gains. [This answer is incorrect. Capital gains reported on Form 1099-DIV are taxable to the shareholder even if the gains are reinvested instead of being distributed. These reinvested gains increase the basis of the mutual fund shares.]

   b. Reinvested taxable and tax-exempt dividends. [This answer is incorrect. Dividends reported on Form 1099-DIV are taxable to the shareholder even if the dividends are reinvested instead of being distributed. These taxable dividends increase the basis of the mutual fund shares. In addition, reinvested tax-exempt dividends from the mutual fund which are reported on Form 1099-INT also increase the basis of the mutual fund shares.]

   c. Undistributed long-term capital gains. [This answer is incorrect. Long-term gains retained by the mutual fund are taxable to the shareholder. These amounts are reported to the shareholder on Form 2439 and increase the basis of the mutual fund shares.]

   d. Nontaxable distributions of return of capital. [This answer is correct. Under the Internal Revenue Code, distributions that are not out of the fund's earnings and profits are a return of capital and generally are not taxable to the shareholder. However, the basis of the mutual fund shares is reduced by the amount of the distribution.]

6. There are three allowable methods for determining the basis of mutual fund shares sold when the shares are acquired at different times. Which of the following methods is **not** an allowable method? **(Page 232)**

   a. Specific identification method. [This answer is incorrect. The specific identification method is an allowable method for determining the basis of mutual fund shares sold. Under this method, the specific shares to be sold must be identified and confirmed.]

   b. First-in, first-out (FIFO) method. [This answer is incorrect. The FIFO method is an allowable method for determining the basis of mutual fund shares sold. This method assumes the shares acquired first are sold first.]

   c. Last-in, first-out (LIFO) method. [This answer is correct. LIFO is not an allowable method under the regulations for determining the basis of mutual fund shares sold.]

   d. Average basis method. [This answer is incorrect. Average basis method is an allowable method for determining the basis of mutual fund shares sold. Taxpayers electing this method must attach election statements to their tax returns indicating whether the single-category or the double-category methods are being used.]

Section 1244 Stock Losses

A taxpayer who incurs a loss on an original investment in Section 1244 stock can treat it as an ordinary loss (rather than a capital loss) up to certain dollar limits. The loss is triggered (1) by either a sale or exchange, or (2) at the time the stock becomes worthless. Section 1244 stock is issued to an individual (or partnership) for money or other property by a domestic small business corporation.

Section 1244 Stock Requirements

Section 1244 stock generally can be either common or preferred stock. However, stock issued before July 19, 1984, must be common stock to qualify for Section 1244 treatment. Common stock does not include securities that are convertible into common stock or common stock that can be converted to other securities. The determination of whether stock qualifies as Section 1244 stock is made when the stock is issued.

A corporation (either C or S) is treated as a small business corporation if, when stock is issued, the aggregate amount of money and other property it received in exchange for stock or as a contribution to capital or paid-in-surplus does not exceed $1 million. Thus, stock associated with the first $1 million of capital (i.e., capital stock and paid-in-capital) can qualify as Section 1244 stock. When total capital exceeds $1 million, the corporation (not the shareholders) may designate the Section 1244 shares issued in that year instead of a proportional allocation. For the stock to receive Section 1244 treatment when it becomes worthless or is sold by the taxpayer, the corporation must have derived more than 50% of its aggregate gross receipts from sources other than investments (such as interest, dividends, royalties) during the five most recent tax years ending before the date the taxpayer's loss is sustained (or since inception if the corporation is in existence for less than five years).

Claiming a Section 1244 Loss

An ordinary loss on Section 1244 stock can be claimed only by an individual to whom the stock was originally issued (or an individual who was a partner in a partnership when it acquired the stock from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership). Shareholders who acquire their stock by gift or inheritance or by purchase from the original holder are not eligible for Section 1244 treatment.

The maximum amount that can be claimed as an ordinary loss in a tax year is $50,000 for a single taxpayer or $100,000 on a joint return. The $100,000 maximum applies whether the losses are sustained by one or both spouses. The $50,000 and $100,000 limitations are annual limitations on the amount treated as ordinary loss under IRC Sec. 1244. Any losses in excess of the $50,000 and $100,000 limitations are treated as capital losses subject to the usual capital loss limitation rules.

For losses sustained by a partnership, the $50,000 and $100,000 limits apply separately to each partner. The partner's share of the partnership's Section 1244 loss is limited to the lesser of his distributive share percentage when the stock is issued or the partner's distributive share percentage when the loss is sustained. (The partnership is considered the original owner.) If the partnership distributes the stock to the partners, they will not be entitled to Section 1244 loss treatment because they are not the original owners.

Losses on Worthless Securities

Taxpayers are allowed a capital loss for worthless securities held as capital assets. The loss can be taken only when the security becomes wholly worthless; losses for partial worthlessness cannot be claimed. This rule requires taxpayers to correctly identify the year that a security becomes wholly worthless.

Generally, a security is considered worthless at the time it first has no liquidation value and no reasonable hope or expectation exists that the security will become valuable at some future date. A taxpayer may be able to establish worthlessness by showing a fixed and identifiable event demonstrating the worthlessness of the security.

The question of when a security becomes worthless has been the subject of many court cases and IRS rulings. For example, bankruptcy is not sufficient to permit a loss claim when it is possible that the shareholders will obtain

stock in a reorganization. In *Thun*, a loss claimed three years before the corporation ceased business was not allowed, but in *Steadman*, a taxpayer's loss two years prior to the corporation filing bankruptcy was allowed. Stock is also worthless at the date a corporation elects to be treated as a disregarded entity if its liabilities exceed the value of its assets, including intangibles, at that date. Worthlessness depends on the particular facts. Practitioners faced with a possible worthless security issue should review relevant court decisions and other authorities. In any event, one court suggested that a loss be claimed in the earliest year possible.

To give taxpayers relief from the obvious difficulties of determining when a security becomes worthless, IRC Sec. 6511(d)(1) allows a seven-year statute of limitations (instead of the normal three-year period) to file an amended return for refund claims due to losses from worthless securities (or bad debts).

Example 1D-1 Timing of worthless stock loss.

Teddy bought 200 shares of HAU Corp. for $15 per share in 1999. HAU is a publicly traded company. As of the end of 2009, the stock price had declined to $1.50 per share, and the company was in Chapter 11 bankruptcy.

Teddy cannot take a worthless stock deduction in 2009 for his anticipated loss on HAU stock. The stock is not wholly worthless—as evidenced by its trading value. To establish a deductible capital loss, Teddy must sell his shares or wait for an event that renders his stock worthless. Even if his ownership interest is significantly diluted in the Chapter 11 reorganization, he will be unable to claim a loss as long as he holds securities that have some value—however nominal. If, however, HAU is liquidated in bankruptcy, Teddy should be able to claim a worthless security loss when it is established that his equity holder class will receive nothing in liquidation.

Abandoned Securities

A loss established by abandonment of a security, other than a security in a corporation affiliated with the taxpayer, that is a capital asset is treated as a loss from the sale or exchange of a capital asset on the last day of the year. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security.

Futures Contracts and Publicly Traded Options

A publicly traded option giving the holder the right to sell a specified stock at a set price (the strike price) on or before a specified date is called a put option. An option giving the holder the right to buy at a set price on or before a specified date is referred to as a call option.

A taxpayer who grants put or call options is called a *writer*. A taxpayer who owns a put or call option is called a *holder*. Writers of options receive a premium or fee for agreeing to take the risk to buy or sell securities under the terms of the option. Holders of options pay the premium to either the option writer or a previous holder to acquire the opportunity to buy or sell securities under the terms of the option.

The following discussions expand on and illustrate the taxation of publicly traded options.

Tax Rules for Option Writers

Option writers (sometimes called *grantors*) have tax consequences when an option (1) lapses without exercise (i.e., expires), (2) is exercised, or (3) is offset by a closing transaction. The receipt of the premium for writing an option has no tax consequences to the writer until one of these events occurs.

Option Lapses (Expires). When a put or call option lapses (expires), the premium payment received by the option writer is a short-term capital gain at that time.

Example 1E-1 Effect of lapse of option on writer.

On November 3, 2009, Ernie wrote a January 2010 put option at $20 per share for 100 shares of QwikBux, Ltd. He received a premium of $250 for writing the option. The stock soared to $28 per share the January 2010 expiration date, and the option was not exercised.

Ernie treats the $250 as short-term capital gain occurring in January 2010. No gain or loss is reported in 2009 since the option is still open at December 31, 2009.

Option Exercised. If a put is exercised (i.e., the writer must purchase the stock), the writer reduces his tax basis in the shares acquired by the amount of premium received. If a call is exercised (i.e., the writer must sell the stock), the writer adds the premium to the proceeds from the sale of the securities to the option holder.

Example 1E-2 Effect of exercise of option on writer.

On October 2, 2009, Buford wrote a December 2009 put option for 100 shares of MightyFine, Inc., at a price of $10 per share. He also wrote a December 2009 call option for 100 shares of Shiftee Stores Corp. at a price of $8 per share. Buford received premiums of $300 for writing the MightyFine put option and $400 for writing the Shiftee Stores call option. Both options were exercised by their holders in December 2009. Buford paid $1,000 to acquire the MightyFine shares and received $800 for delivering 100 shares of Shiftee Stores.

Buford's tax basis in the 100 shares of MightyFine that he now holds is $700 ($1,000 paid to acquire the shares − $300 premium received for writing the put option).

Buford's sales proceeds from the 100 shares of Shiftee Stores delivered to the call option holder (i.e., $800) are increased by the $400 received for writing the call option on the shares. He then calculates capital gain or loss using his basis and his holding period in the shares delivered.

Closing Transaction. A closing transaction occurs when the writer's economic obligation under the option's terms is offset and, in effect, canceled by purchase of an equivalent option. If an option writer enters into a closing transaction, any gain or loss is short-term and is measured by the difference between the amount received from premiums for writing the option and the amount paid to acquire options in the closing transaction.

Example 1E-3 Effect of closing transaction on writer.

Assume the same facts as in Example 1E-2, except Buford decides he wants to avoid the consequences of having the options he wrote exercised. Therefore, he acquires offsetting positions on December 1, 2009, by purchasing a December 2009 put option for 100 shares of MightyFine (at $10 per share) for $400 and a December 2009 call option for 100 shares of Shiftee Stores (at $8 per share) for $600.

Buford has a $100 short-term capital loss from his MightyFine option writing ($300 premium received − $400 paid in closing transaction) and a $200 short-term capital loss from his Shiftee Stores option writing ($400 premium received − $600 paid in closing transaction). These losses are recognized on December 1, 2009, the date the closing transactions occurred.

Tax Rules for Option Holders

The tax consequences to option holders depend on whether the options expire, are exercised, or are sold before expiration. To summarize:

1. The loss on an expired option will be either short-term or long-term depending on how long the option was held, unless the option is part of a straddle (see discussion below).

2. If a put option is exercised (i.e., the holder sells the stock to the option writer), the cost of the option is deducted from the sales proceeds received from the sale of the securities under the terms of the put.

3. If a call option is exercised (i.e., the holder buys the stock from the option writer), the cost of the option is added to the cost of the securities acquired under the terms of the call.

4. If an option is sold prior to expiration, gain or loss will be either short- or long-term depending on how long the option was held (see holding period rules for options included in straddles below).

Example 1E-4 Effects of option transactions on holder.

On March 5, 2009, Selena made the following option transactions: (1) bought an April 2009 call option to purchase 100 shares of McD, Ltd., at $15 per share for $150, (2) bought a June 2009 put option to sell 100

shares of Fort, Inc., at $10 per share for $250, and (3) bought a December 2009 call option to purchase 100 shares of Luckee, Inc., at $7 per share for $100.

On March 5, 2009, Selena did not own any shares in McD, Ltd., Fort, Inc., or Luckee, Inc. On March 16, 2009, Selena sells her McD option for $600, recognizing a $450 short-term capital gain.

On June 18, 2009, Fort was selling for $14 per share; thus, Selena let the option expire. She has a short-term capital loss of $250 when it expires because she held it for one year or less.

On December 18, 2009, Luckee is selling for $15 per share, and Selena exercises her option. Her option cost of $100 is added to the $700 paid to exercise the call; so her basis in the shares is $800. Her stock's holding period starts on December 19, 2009, the day after she acquired the shares by exercising her option.

Put Options Treated as Straddles. Purchasing a put option on stock owned by the taxpayer can result in the application of the straddle rules under IRC Sec. 1092. Holding a position [including an option to buy (other than a qualified covered call as described in IRC Sec. 1092) or sell] that substantially diminishes a taxpayer's risk of loss of holding property is a straddle. Although stock is generally excluded from the definition of personal property when applying the straddle rules, it is included when it is part of a straddle in which at least one of the offsetting positions is an option to buy or sell the stock or substantially identical stock or securities. However, a straddle consisting entirely of regulated futures contracts, nonequity options (e.g., an option on the S&P 500 index), or dealer equity options is not subject to this rule. Instead, the mark to market rules apply.

If the straddle rules apply, losses on positions making up the straddle may be deferred until the year any gains are recognized on the remaining position(s). Loss is deferred to the extent of unrecognized gain in the offsetting positions, determined as of the close of the year. For a protective put (i.e., a put option acquired with respect to stock owned by the option holder), any loss incurred because the option expires unexercised is deferred to the extent the stock would generate a gain if sold on the last day of the tax year. If the straddle rules apply, the option's holding period is also subject to special rules. If the taxpayer held the stock subject to the option for more than 12 months before purchasing the put option, any loss on the option's expiration is long-term. If the taxpayer held the stock subject to the option for 12 months or less before acquiring the put, the option's holding period does not begin until the offsetting position (i.e., the stock) is sold. Thus, if the option expires before the stock is sold, the loss is short-term. Also, any interest and carrying charges associated with the straddle must be capitalized.

Example 1E-5 Applying the straddle rules to expired put options.

Assume the same facts as in Item 2 of Example 1E-4. Also assume that Selena owns 100 shares of Fort, Inc., that she purchased three years ago for $5 per share. Selena does not sell the Fort stock during 2009. At December 31, 2009, it is worth $14 a share. Thus, Selena has an unrecognized gain with respect to the Fort stock of $900 [($14 FMV less $5 basis) × 100 shares]. None of the loss on the expired put can be recognized during 2009 since the $900 unrecognized gain in the Fort stock exceeds the $250 loss on the expired put.

Variation: Assume instead that Selena's basis in the 100 shares of Fort is $20 per share. Thus, at December 31, 2009, she has an unrecognized loss of $600 [($14 FMV − $20 basis) × 100 shares]. Selena recognizes the $250 long-term loss when the put option expires (June 19, 2009). This is because the stock she owns would not generate a gain (if sold on December 31, 2009) that exceeds the loss she realized on the expiration of the option. In fact, in this situation, a sale of the stock would result in a loss.

Straddles and Qualified Covered Call Options. Under a special rule in IRC Sec. 1092(c)(4), a straddle consisting of a stock and a qualified covered call option on the stock do not constitute a straddle for purposes of the loss deferral rules unless such positions are part of a larger straddle. This exception to the straddle rules normally applies when an individual writes a publicly traded call option on stock he owns as an investment strategy to enhance the investment return on the stock.

A qualified covered call option is any option a taxpayer grants to purchase stock he holds (or stock he acquires in connection with granting the option), but only if all of the following are true: (1) the option is traded on a national securities exchange or other market approved by the Secretary of the Treasury, (2) the option is granted more than 30 days before its expiration date, (3) the option is not a deep-in-the-money option [i.e., an option with a strike price

lower than the lowest qualified benchmark (LQB); generally, the LQB is the highest available strike price that is less than the applicable stock price], (4) the taxpayer is not an options dealer who granted the option in connection with his activity of dealing in options, and (5) gain or loss on the option is capital gain or loss.

In Rev. Rul. 2002-66, the IRS ruled that if a taxpayer owns stock on which he or she has written a qualified covered call option and acquires a put option on the same stock, the presence of the put option causes the stock and qualified covered call option to constitute a larger straddle and thus, no longer qualify for the exception to the straddle rules. The taxpayer is then subject to the loss deferral and other restrictions applicable to straddle positions, as discussed earlier.

Example 1E-6 Acquiring a put option disqualifies covered call option from straddle exception.

On October 2, 2009, Tom purchases 100 shares of ABC Corp. for $102 per share. On October 5, 2009, when the fair market value of ABC stock is $100, Tom writes a 12-month qualified covered call option on the 100 shares with a strike price of $110. On December 4, 2009, when the FMV of the stock remains at $100, Tom purchases a 12-month put option on 100 shares of ABC stock with a strike price of $95.

Before December 4, 2009, the combination of the qualified covered call option and the underlying ABC stock are not treated as a straddle for purposes of IRC Sec. 1092 and 263(g). However, beginning on December 4, 2009, all of the Tom's positions in ABC stock are part of a larger straddle and therefore, the exception for covered call options no longer applies to any of them beginning on that date. Thus, a loss realized on any part of the straddle (i.e., the ABC stock, the call option, or the put option) after December 4, 2009 could be recognized only to the extent it exceeded any unrecognized gain in the offsetting positions (determined at the close of the tax year). (See Example 1E-5.)

Section 1256 Contracts

IRC Sec. 1256 was enacted to curb abuse in the futures contract markets whereby taxpayers could accelerate the recognition of loss on a contract even though they held another contract with an offsetting but unrealized gain that would be recognized in the future. The abuse has been curtailed by requiring each Section 1256 contract held by the taxpayer at the end of the year to be treated as having been sold at FMV on the last day of the business year (i.e., marked to market). When the contract is subsequently closed in a future tax year, gain or loss realized is adjusted to account for gain or loss resulting from the prior year's marking to market. Any gain or loss from a Section 1256 contract is automatically treated as 60% long-term and 40% short-term capital gain or loss. Any loss on a Section 1256 contract recognized due to the mark to market rules is exempt from the wash sale rules described later in this lesson.

A *Section 1256 contract* is defined as any:

1. regulated futures contract (i.e., a contract that is traded on or subject to the rules of a qualified board or exchange, and for which the amount that must be deposited or withdrawn depends on a system of marking to market);

2. foreign currency contract (i.e., forward purchases or sales of foreign currency);

3. nonequity option (e.g., listed options on commodities, futures, foreign currencies, etc.); or

4. dealer equity option (i.e., an equity option granted or purchased by an options dealer in the course of the dealer's business as a market maker in listed options).

The taxpayer can elect to carry a net Section 1256 loss back to the three previous tax years. A net Section 1256 loss for the year is the lesser of (1) the net loss on Section 1256 contracts for the year, or (2) the amount allowable as a capital loss carryover for the year. The amount that can be carried back cannot exceed the net Section 1256 gains for the year to which the loss is carried. A net Section 1256 gain for the year is the lesser of (1) the capital gains for the year considering only gains and losses from Section 1256 contracts, or (2) capital gain net income for the year. The election is made by checking box D on Form 6781.

Example 1E-7 Marked to market treatment of Section 1256 contracts.

John, a speculator, had an open position on a corn contract on December 31, 2008, with an unrealized profit of $3,500, which he recognized in 2008 per IRC Sec. 1256. When he closed the contract on June 2, 2009, he realized a profit on the contract of only $2,000 (reflecting a price decline since December 31, 2008).

John also entered into a futures contract in 2008 calling for delivery of 10,000 bushels of soybeans in May 2009 at $6 per bushel. On December 31, 2009, John still holds the contract, and the May soybean futures price has declined to $5.50 per bushel. How does John treat the decline in the price of the soybean futures on December 31, 2009?

In 2009, John recognizes a $1,500 loss on the corn contract and a $5,000 (10,000 × $.50) loss on the soybean futures contract. The aggregate loss of $6,500 is treated as $3,900 (60% × $6,500) long-term and $2,600 (40% × $6,500) short-term. John reports the transaction on Form 6781 (Gains and Losses From Section 1256 Contracts and Straddles), Part 1. Additionally, he can elect (on Form 6781) to carry a net Section 1256 loss back to the three previous tax years as discussed previously.

Example 1E-8 Section 1256 treatment when contract is closed.

Assume the same facts as in Example 1E-7. In March 2010, John closes out the soybean contract by offset when the May price is $6.75. How much gain does he recognize from this transaction in 2010?

The contract is again marked to market in 2010 for a total gain of $7,500 [($6.75 − $6.00) × 10,000)]. However, this gain is adjusted to reflect the $5,000 loss recognized in 2009. As a result, John recognizes a total gain of $12,500 in 2010. The gain is treated as a $7,500 (60% × $12,500) long-term and a $5,000 (40% × $12,500) short-term capital gain.

Short Sales

What Is a Short Sale?

A *short sale* occurs when a taxpayer sells borrowed securities. A short seller is betting that the price of the securities will decline. If it does, he can buy the securities (at the lower price) to replace those borrowed and sold short, and profit from the price difference. The short sale itself is not a taxable transaction. However, when the seller "covers" by delivering securities to the lender to replace those borrowed for the original short sale, a taxable sale is completed. While the short position is open, the taxpayer is charged interest to the extent the market value of the securities rises above the sales price plus commissions.

General Tax Consequences

Taxable gain or loss is computed based on the difference between the proceeds from the short sale and the tax basis of the securities delivered to cover. The holding period of the securities used to cover generally determines whether the gain or loss is short- or long-term. However, special holding period rules apply to prevent taxpayers from using short sales to convert short-term gains into long-term gains and long-term losses into short-term losses. These special rules under IRC Sec. 1233 are as follows:

1. If, on the date of the short sale, substantially identical property has been held by the taxpayer (or spouse) for a period less than one year (or if substantially identical property is acquired after the short sale, but before the closing of the short sale by replacement of the borrowed securities), the holding period is deemed short-term regardless of how long the securities actually used to cover have been held. This rule applies only to gains.

2. If, on the date of the short sale, substantially identical property has been held by the taxpayer (or spouse) for more than one year, any loss from the short sale will be deemed to be long-term regardless of the holding period of the securities actually used to cover. This rule applies only to losses.

3. These deemed holding period rules apply only to the quantity of shares sold short.

The term *substantially identical property* is to be applied according to the facts and circumstances in each case.

Example 1F-1 Recognizing gain or loss on a short sale.

On March 17, 2009, Jenny borrows 100 shares of MXL stock from her broker and sells it short for $5,000 ($50 a share). She did not own any MXL stock at the time. On April 30, 2010, Jenny purchases 100 MXL shares for $6,000 and delivers them to her broker to close the short sale. Jenny does not report any gain or loss from the short sale until April 30, 2010, the date she closes it. She reports a $1,000 short-term capital loss in 2010 because the holding period for the delivered stock was less than one year.

Variation: Assume that when Jenny sold the stock short, she held 100 shares of MXL stock she had acquired on January 20, 2009, for $3,500. Here, Jenny's MXL stock is considered an appreciated financial position subject to the constructive sale rules. Thus, she must recognize a $1,500 short-term capital gain on March 15, 2009, the date she enters into a constructive sale of her MXL stock (the date of the short sale of other MXL stock).

Transferring borrowed stock to cover a short sale obligation does not close that sale. The sale remains open until it is finally discharged (generally, by delivering stock that the taxpayer owns or purchases to the second lender). However, if property sold short becomes substantially worthless before being delivered to close the transaction, the short sale is treated as closing and gain is recognized as of the date the property became substantially worthless. This prevents a taxpayer from deferring gain recognition.

Example 1F-2 Reconciling short sale proceeds.

Sally sold several stocks in her investment portfolio during 2009. The proceeds from these sales totaled $189,500. She also sold short 100 shares of Bubble.com stock for $62,200 and the short position was still open on December 31, 2009. However, Blue Sky Securities, Inc., Sally's brokerage firm, reported sales proceeds of $251,700 ($189,500 + $62,200) on the Form 1099-B issued to her.

The IRS will expect Sally's 2009 Schedule D to reflect securities sales of $251,700 (i.e., match the Form 1099—B amount). Sally should attach a reconciliation statement in support of Schedule D, as follows:

Gross proceeds per Form 1099—B	$ 251,700
Less: nontaxable short sale open at December 31, 2009	(62,200)
Reportable proceeds	$ 189,500

Applying the Constructive Sale Rules

The Section 1259 constructive sale rules that apply to taxpayers holding appreciated financial positions also apply to certain short sale transactions. The constructive sale rules are discussed later in this lesson. With regard to short sales, the constructive sale rules cause a taxpayer owning an appreciated security who enters into a short sale with respect to that security to recognize gain at the time of the short sale (rather than when the short sale is closed). This rule, which effectively eliminates short-against-the-box as a year-end gain deferral technique, applies unless an exception to the constructive sale rules applies.

Rev. Rul. 2002-44 clarifies how the constructive sale rules apply when a taxpayer acquires stock to close an appreciated short position. Under the ruling, if a taxpayer is holding a short position that has increased in value (because the underlying asset has decreased in value), merely acquiring the property to close the sale will trigger the gain (under the constructive sale rules), regardless of Reg. 1.1233-1(a)(1), which says gain or loss is recognized on the date the property is delivered to close the sale.

Example 1F-3 Recognizing loss on a short sale.

Courtney sells 100 shares of Acme Inc. (a publicly traded stock) short on October 30, 2009 when Acme is trading at $40 per share. Courtney does not own any Acme, Inc. stock. On December 29, 2009, Acme is

trading at $43 per share, so Courtney's short position has declined in value. She instructs her broker to acquire 100 shares of Acme to close her short sale. The trade date of the purchase is December 29, 2009, but the shares are not delivered to the lender to close the short sale until January 2, 2009. Courtney does not realize her loss on the short sale until January 4, 2010.

Example 1F-4 Recognizing gain on a short sale.

Assume the same facts as Example 1F-3, except that on December 29, 2009, the Acme Inc. stock is worth $35 per share. Now, Courtney's short position is an appreciated financial position. So, when her broker purchases (on her behalf) the stock to close the transaction on December 29, 2009, the constructive sale rule applies. Courtney recognizes her gain on the short sale on December 29, 2009 (the trade date), even though the shares are not delivered to the lender to close the sale until January 4, 2010.

Applying the Wash Sale Rules

A discussion of wash sales continues later in this lesson. Under IRC Sec. 1091(e), wash sale principles also apply to short sale loss transactions when another short sale of substantially identical securities is entered into within 30 days before or after the closing of the short sale giving rise to a loss.

Example 1F-5 Short sale that is also a wash sale.

Will is convinced that DiveTech's stock value will decline, so on October 2, 2009, he sells 1,000 shares short at $30. The stock rises, and on December 4, 2009, DiveTech is selling for $35 a share. Will could use a 2009 short-term loss for tax purposes, so on December 4, 2009, he buys 1,000 shares at $35 and covers his short position. With his $5,000 short-term loss presumably recognized in 2009, Will sells another 1,000 shares of DiveTech short at $35 on December 7, 2009, because he is still convinced that DiveTech inevitably will decline.

In this case, Will entered into a short sale of identical stock three days after the December 4, 2009 closing of his original short position that gave rise to the $5,000 loss. Will's $5,000 loss will be deferred and added to the tax basis of the securities eventually delivered to close out his December 7, 2009, short position.

Employee Stock Options

Two basic kinds of stock options are received as compensation by employees—incentive stock options (ISOs, also referred to as qualified or statutory stock options) and nonqualified stock options (NQSOs).

Incentive Stock Options

An ISO can have both regular tax and alternative minimum tax (AMT) implications. (See "AMT Considerations" later in this key issue.) Generally, the recipient of an ISO recognizes no income for regular tax purposes upon the grant (when the option is received) or the exercise (when converting the option to stock) of the ISO. The price at which the option is exercised becomes the taxpayer's basis in the stock; the taxpayer then recognizes income on the difference between his basis and the sales price when the stock is sold. When stock received from the exercise of an ISO is sold, the transaction receives capital gain treatment if the participant has held the stock for at least one year, and the ISO was granted at least two years before.

If this holding period requirement is not met, the taxpayer will have a disqualifying disposition when the stock is sold. Generally, if the employee sells the stock within two years of the grant date or one year of the exercise date, the difference between the option (exercise) price and the fair market value (FMV) on the date it is exercised (i.e., the bargain element) is ordinary income to the employee. If the amount realized upon the sale of the stock exceeds the FMV at the exercise date, the excess of sales price over the FMV at the exercise date is capital gain. However, if the amount realized is less than the FMV at the date of exercise and greater than the exercise price, only the excess of the amount realized (not the FMV) over the exercise price is taxed as ordinary income. This limitation on compensation income recognized only applies if the disposition is a sale or exchange on which a loss, if sustained, would be recognized. For example, if the stock is sold to a related party (under IRC Sec. 267) at a price less than the FMV at the date of exercise, the compensation amount is the excess of the exercise price over the option price.

If the amount realized is less than the exercise price, the excess of the exercise price over the amount realized is capital loss.

Example 1G-1 Disqualifying disposition of ISO stock.

Brian is an executive with Gem Corp. In January 2007, he was granted ISOs to purchase 2,000 shares of Gem's stock at $50 per share (which was the market price of its stock on that date). Brian exercises the options in February 2009 when the stock is trading at $61 per share; no regular tax consequences occur. His regular tax basis in the 2,000 shares is $100,000 (the exercise price). (However, AMT tax consequences exist at the time of exercise. See the discussion following this example.)

Brian sells the 2,000 shares in December 2009 for $134,000 (2,000 shares × $67 per share), realizing a $34,000 ($134,000 − $100,000) gain for regular tax purposes. Brian's sale of the stock within one year of the date the option was exercised is a disqualifying disposition. Therefore, Brian must recognize $22,000 (of the total $34,000) as ordinary income for regular tax purposes in 2009, computed as follows:

	Value of stock on exercise date (2,000 shares × $61)	$ 122,000
	Exercise price paid (2,000 shares × $50)	(100,000)
(1)	Excess of value over exercise price	$ 22,000
	Amount realized from the stock disposition (2,000 shares × $67)	$ 134,000
	Exercise price paid (2,000 shares × $50)	(100,000)
(2)	Excess of amount realized over exercise price	$ 34,000
	Ordinary income [lesser of (1) or (2)]	$ 22,000

The $22,000 is compensation income and is reported to Brian on either Form W-2, box 1 (for employees), or Form 1099-MISC (for former employees). The remaining $12,000 of gain realized on the sale ($34,000 − $22,000) is short-term capital gain (reported on Schedule D) because Brian held the stock for one year or less.

An employee has three months after termination of employment to exercise an ISO. The option generally must be exercised within three months of the employee's last day of employment by the corporation, its parent, or its subsidiary. Thereafter, the option becomes nonqualifying, resulting in less favorable tax treatment (see discussion later in this key issue). When an employee terminates employment because of permanent and total disability, the three-month period is extended to one year.

When an ISO is exercised, the employer must furnish a statement to the participant. It should include such data as the FMV of the stock received the exercise price per share, and the tax consequences of the exercise of the option and the eventual sale of the stock. Practitioners should review this information during the return preparation process.

AMT Considerations. The difference between the option price and the FMV on the date the option is exercised (unless the stock is subject both to restrictions on transferability and a substantial risk of forfeiture) is a positive AMT adjustment, increasing alternative minimum taxable income (AMTI), which may trigger AMT in the year an ISO is exercised. The taxpayer's stock basis for AMT is FMV at the date of exercise (cost plus amount included in AMTI as an adjustment). A taxpayer disposing of the stock will have a negative AMT adjustment for the excess of the basis for AMT over the basis for regular tax. If the stock is disposed of in the same year as exercise, the two adjustments will offset, and the tax effect will be the same for both regular tax and AMT. A taxpayer may avoid the application of AMT resulting from an ISO exercise by staggering it so that the adjustment does not trigger AMT.

Alternatively, a taxpayer with AMT as a result of an ISO exercise will have a minimum tax credit (MTC) available to offset regular tax in future years. If the MTC is not used in the next three years, it becomes part of the taxpayer's long-term unused MTC, which can generate a refund. This AMT refundable credit is equal to the greater of 50% of the long-term unused MTC for the tax year or the amount (if any) of the AMT refundable credit amount determined under IRC Sec. 53(e) for the taxpayer's preceding year. Thus, although an individual may have to pay AMT when

exercising an ISO, he or she can use any resulting MTC twice (e.g., half in one year and half in the next year) to compute the AMT refundable credit amount for each of two consecutive tax years, beginning with 2008.

Nonvested Stock. The stock received upon exercising an ISO may be subject to forfeiture (i.e., nonvested). For regular tax, receiving nonvested stock is no different than receiving vested stock if the holding period requirements are met. However, if the nonvested stock is sold in a disqualifying distribution (i.e., after it vests but before the holding period requirements are met), the ISO rules no longer apply. Therefore, compensation income is recognized at the sale date, equal to the excess of the stock's FMV on the date it vests (or, if less, the sales price, assuming the sale is not subject to loss deferral) over the exercise price. The stock's holding period begins on the vesting date.

Example 1G-2 Nonvested stock received by exercising an ISO.

In June 2007, Courtney, an executive with Round Top Enterprises, is granted an ISO to purchase 100 shares of stock at $100 per share. When the option is exercised, the stock cannot be transferred for six months. Courtney exercises the option in February 2008, when the stock price is $120 a share. On August 8, 2008, the stock vests. It is trading for $130 a share on that day. In February 2009, Courtney sells the stock for $150 a share. This is a disqualifying disposition because the ISO was granted less than 2 years before the stock was sold. Courtney recognizes compensation income of $3,000 [($130 − 100) × 100]. She also recognizes capital gain of $2,000 [(150 − 130) × 100]. This is a short-term capital gain because Courtney's holding period began on August 8, 2008 (the day the stock vested).

New regulations on an employer's reporting requirements upon the transfer of stock pursuant to the exercise of an ISO have been proposed but were not finalized at the time this course went to press. These proposed regulations require that essentially the same information currently reportable to an employee under Reg. 1.6039-1 also be reported to the IRS.

Nonqualified Stock Options (NQSOs)

An NQSO is any option that is not a qualified stock option, as defined in IRC Sec. 422. Unlike ISO holders who meet the required holding period, the recipient of an NQSO is not allowed to defer income recognition on the bargain element until the stock is sold or to have all the income associated with the option treated as capital gain.

Generally, the excess of the stock's FMV when the option is exercised over the option price (i.e., the bargain element) is taxable as compensation in the year of exercise. However, if the FMV of the option is readily ascertainable when the option is granted, income will be recognized then rather than when the option is exercised. From an employee's perspective, this may be the most advantageous time for income recognition if the stock value increases significantly after the option is granted. Unfortunately, if the option is not traded, it can be difficult to determine whether the option has a readily ascertainable FMV. An option does not have a readily ascertainable FMV unless the following conditions are met:

1. The option may be transferred freely.

2. The option is exercisable immediately in full.

3. There are no restrictions on the option or stock that have a significant effect on the FMV of either.

4. The FMV of the option privilege can be determined by the value of the property subject to the option, the probability of an increase or decrease in value, and the length of the option period.

The burden is on the taxpayer to prove that an option has a readily ascertainable value. Most NQSOs do not have a readily ascertainable value, and are therefore not taxed at the grant date.

Example 1G-3 Taxation of NQSOs.

Tom is an executive with Smith Corp., a closely held company. On March 1, 2006, he was granted NQSOs to purchase 3,000 shares of Smith Corp. stock at $30 per share (which was the market price of the stock on that

date). The options have some restriction on transferability and therefore do not have a readily ascertainable FMV. Tom exercises the options on March 3, 2009, when the stock is trading at $45 per share.

Since the options had no readily ascertainable FMV at the grant date, there was no taxable event on that date. However, Tom must recognize $45,000 ($15 per share bargain element × 3,000 shares) of ordinary compensation income in 2009 when the options are exercised. Tom's basis in the stock is $135,000, or $45 per share ($30 per share option price + $15 per share compensation income × 3,000 shares). If he holds the stock as a capital asset for more than one year before he sells it, he will receive long-term capital gain (or loss) treatment.

Variation: If the options themselves had a readily ascertainable FMV of $5 per option at the date of grant (March 1, 2006), the value of the options ($5 × 3,000 = $15,000), is taxable to Tom in 2006 as ordinary compensation income. There would be no tax consequences to Tom in 2009 when he exercised the options. Tom's basis in the stock would be $105,000, or $35 per share (option price of $30 per share + $5 per option of compensation income recognized). If Tom holds the stock as a capital asset for more than one year after exercise before he sells it, he will receive long-term capital gain (or loss) treatment.

Example 1G-4 Cashless exercise of NQSOs.

Assume the same facts as in Example 1G-3 except that Tom exercises the NQSOs in a cashless transaction. Tom works with a brokerage firm that pays Smith Corp. $90,000 ($30 × 3,000 shares) on March 3, 2009 to purchase the NQSO shares on Tom's behalf. The brokerage firm immediately sells 2,000 shares for $90,000 ($45 per share) and uses the funds to repay Tom's margin loan.

Tom must recognize $45,000 ($15 per share bargain element × 3,000 shares) of ordinary compensation income in 2008 when the options are exercised. His basis in the remaining 1,000 shares of stock is $45,000 or $45 per share ($30 per share option price + $15 per share compensation income × 1,000 shares). If Tom holds the remaining 1,000 shares of stock as a capital asset for more than one year before he sells it, he will receive long-term capital gain (or loss) treatment on those shares.

The option may pertain to stock that is nontransferable or subject to a substantial risk of forfeiture (i.e., restricted stock). Here, compensation income generally is not recognized until the restrictions lapse, and it is based on the difference between the FMV of the stock when the restrictions lapse less the exercise price. This can be detrimental to the employee if the stock appreciates after the option is exercised and before the restrictions are lifted. Accordingly, if the stock is expected to appreciate, the employee might want to elect under IRC Sec. 83(b) to recognize the income when the option is exercised rather than when the restrictions lapse based on the appreciated value.

In *Hilen*, taxpayer borrowed funds from a commercial bank, used the borrowed funds to exercise stock options, and pledged the stock as collateral for the bank loan. Taxpayer recognized income equal to the difference between the exercise price and the fair market value and paid taxes on that gain. The stock subsequently declined in value, the taxpayer defaulted on his bank loan, and he filed an amended return reversing the recognition of income on the option gain. Taxpayer claimed the option exercise was nonrecourse financing, that he should not have to bear the risk of market value decline, and the recognition of gain should be delayed until he made a substantial payment on the debt. The court ruled the debt was recourse financing and the taxpayer must recognize income from the exercise of his nonstatutory stock options as stated in the original tax return.

So long as the sale of property (e.g., stock) at a profit could subject a person to suit under Section 16(b) of the Securities Exchange Act of 1934, such person's rights to such property are subject to a substantial risk of forfeiture. For stock acquired as a result of exercising an NQSO granted prior to an IPO, the six month holding period for Section 16(b) generally begins when the NQSO was granted, not when it was exercised.

Qualified Small Business Stock

Qualified small business stock (QSBS) is stock originally issued after August 10, 1993, by a C corporation with aggregate gross assets not exceeding $50 million at any time from August 10, 1993, to immediately after the issuance of the stock. The taxpayer must have acquired the stock at its original issue, or in a tax-free transaction such as a gift, inheritance, or partnership distribution.

In addition, the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded. Ineligible businesses include certain personal service activities, banking and other financial services, farming, mineral extraction businesses, and hotels and restaurants. Thus, businesses such as manufacturing, wholesale or retail trade, and transportation activities generally qualify. QSBS can be acquired either in exchange for money or other property (but not stock) or as compensation for services.

When QSBS is sold, the normal capital gain and loss rules apply unless the stock is sold for a gain and either (1) held for more than five years under the 50% gain exclusion rule, or (2) held for more than six months and the sales proceeds are rolled over into other QSBS within 60 days under the Section 1045 rollover rules.

50% Gain Exclusion

Noncorporate taxpayers can exclude 50% of any gain realized from the sale of QSBS held more than five years. When the 50% exclusion applies, the remaining 50% of the gain is taxed at a 28% capital gains rate. Thus, the entire gain is taxed at an effective rate of 14% (50% of gain taxed × 28% rate). But, 7% of the excluded gain is an AMT preference item. Thus, for taxpayers subject to the 28% AMT rate, the effective rate on gains from Section 1202 stock is 14.98% [28% × (50% plus 7% × 50%)].

The gain eligible for exclusion for each taxpayer is limited on a per issuer basis and cannot exceed the greater of (1) $10 million reduced by the taxpayer's aggregate prior-year gains from stock of the same issuer, or (2) 10 times the taxpayer's basis in his QSBS from such corporation disposed of during the year.

Rollover of QSBS Gain

Under IRC Sec. 1045, noncorporate taxpayers who realize a gain from the disposition of QSBS held more than six months can elect to roll over (defer) the gain to the extent they acquire QSBS during the 60-day period beginning on the date of the sale. Gain is recognized to the extent the sales proceeds exceed the cost of replacement stock(s) reduced by any part of the cost of the replacement QSBS that was previously taken into account to defer recognition of gain on the sale of other QSBS. Gain treated as ordinary income is not eligible for rollover. When determining whether the replacement QSBS meets the Section 1202(c)(2) active business requirement, only the first six months the taxpayer holds the stock is taken into account.

The basis in the QSBS acquired is reduced for any gain deferred. In addition, the holding period of the replacement stock generally will include the holding period of the stock sold, except the replacement stock must be held for more than six months to do another tax-free rollover.

Example 1H-1 Rollover of gain on small business stock.

Charlie invests $400,000 in Eagle Corp., a manufacturing concern, on August 22, 2008. Eagle stock qualifies as small business stock under IRC Sec. 1202(c). On October 2, 2009, Charlie sells the Eagle stock for $625,000, resulting in a $225,000 gain. On October 13, 2009, he purchases stock in newly formed Hawk Corp. for $600,000. Hawk also qualifies as a small business corporation under IRC Sec. 1202(c).

Charlie elects to roll over the gain from the sale of the Eagle stock. Accordingly, he recognizes only $25,000 of the gain because this is the amount the sales proceeds ($625,000) exceed his investment in Hawk ($600,000). His basis in his Hawk stock is $400,000 ($600,000 cost less deferred gain of $200,000). His holding period in Eagle stock is added to the holding period of the Hawk stock for all purposes except for determining whether Hawk meets the active business requirement for the six-month period following purchase.

A taxpayer (other than a C corporation) that sells QSBS and elects to defer gain can satisfy the replacement QSBS requirement with QSBS that is purchased within the statutory period by a partnership in which the taxpayer is a partner on the date the QSBS is purchased (purchasing partnership). In addition, an eligible partner of a partnership that sells QSBS (selling partnership) and elects to defer gain can satisfy the replacement QSBS requirement with QSBS purchased by a purchasing partnership during the statutory period.

Wash Sale Losses

A loss from the sale or disposition of stock or securities is not deductible if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities. Stock or securities include stock options, but do not include commodity futures contracts and foreign currencies. In addition, dealers in stocks or securities are not subject to these rules if the loss is from a transaction made in the ordinary course of business. The wash sale rules apply only for losses; gains resulting from wash sales are taxable in the year of sale.

When a wash sale deferred loss transaction occurs, the basis of the substantially identical securities is increased by the realized but unrecognized loss. The holding period of the acquired securities includes that of the original stock sold.

Some taxpayers have tried to circumvent the wash sale rules by having a related party purchase the replacement stock or securities. Although the Section 1091 wash sale rules do not specifically apply to related parties, the courts generally have not allowed the loss in these situations. In *McWilliams*, the court found that the sale by one taxpayer and the purchase by a related taxpayer should be collapsed into a single related party transaction, resulting in loss disallowance under IRC Sec. 267. The Section 267 related party loss disallowance rules are even more onerous than the wash sale rules since they cannot be avoided by timing the sale and repurchase to avoid the 61-day window. Also, the disallowed loss does not automatically increase the basis in the acquired securities. Instead, it can only be used to offset any subsequent gain on a sale by the related party. Taxpayers and their IRAs are related parties. Thus, the sale of a security at a loss would be disallowed if, as part of a plan, the taxpayer's IRA purchased an identical security.

For the wash sale rules to apply, the stocks or securities must be substantially identical. All facts and circumstances must be considered in each case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. Also, IRC Sec. 1091 is not intended to apply to bona fide sales made to reduce a taxpayer's holdings of a security. Thus, a taxpayer who simply buys 200 shares of a stock and within the next 30 days sells 100 shares at a loss will not have the loss disallowed under the wash sale rules. However, the rules will apply if additional shares are acquired within the 30 days following the sale at a loss.

When a Form 1099-B is received for a loss transaction that is a wash sale, the transaction must be reported on Schedule D to avoid IRS matching problems.

Example 1l-1 Accounting and reporting for a wash sale.

Robert purchased 100 shares of XYZ Corp. stock on July 3, 2009, for $700. On September 4, 2009, he sold the shares for $500. On September 11, 2009, he purchased another 100 shares of XYZ for $600. Robert received a 2009 Form 1099-B reflecting the $500 sale on September 4, 2009.

Because the sale and subsequent repurchase of the XYZ stock is a wash sale, the $200 loss from the September 4 sale is not deductible. Instead, Robert's basis in the 100 shares acquired on September 11, 2009, is adjusted to $800 [cost of the reacquired shares ($600) plus the disallowed wash sale loss ($200)]. In addition, the holding period for the shares acquired on September 11 includes the July 4–September 4 holding period for the original 100 shares.

The wash sale is reported on Part I of Schedule D (since it is a short-term transaction). The full amount of the loss is shown in column (f). On the next line, "Wash Sale" is entered in column (a), and the amount of loss not allowed is shown in column (f) as a positive amount.

Constructive Sales of Appreciated Financial Positions

General Rules

The *constructive sale* rules require recognition of gain (but not loss) upon a constructive sale of any appreciated financial position in stock, a partnership interest, or debt other than certain straight debt. These rules are aimed at

transactions that have the effect of eliminating substantially all of a taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position.

A *constructive sale* occurs when the taxpayer (or a related person) enters into one of the following transactions for the same or substantially identical property:

1. a short sale;

2. an offsetting notional principal contract;

3. a futures or forward contract;

4. an acquisition of the actual property (i.e., a long position) that is the subject of a transaction listed in Items 1–3; or

5. under forthcoming regulations, a transaction that has substantially the same effect as an item in 1–4.

The gain is calculated as if the property were sold, assigned, or otherwise terminated at its fair market value (FMV) on the date of the constructive sale. The property's basis is increased by gain recognized on the constructive sale.

Example 1J-1 Collar transaction may result in constructive sale of stock.

Amy owns 100 shares of Allied Corp. stock with a basis of $65 a share and currently trading at $100 a share. She enters into a collar transaction whereby she buys a put option on Allied stock with a strike price of $95 and sells a call option on Allied stock with a strike price of $110. Thus, Amy has retained the risk of loss and opportunity for gain as long as the stock trades between $95 and $110 a share. Outside of that range, she is protected from further loss or opportunity for gain because the option transactions she entered into collar her stock.

Without indicating whether this is a constructive sale, Congress used this fact pattern as an example of a collar transaction in the TRA '97 Committee Reports and went on to state that it expects the IRS to provide safe harbor rules so investors know when collars will be treated as constructive sales. Practitioners should monitor this issue for guidance.

Definitions

Appreciated Financial Position. An *appreciated financial position* is any position relating to a stock, debt instrument, or partnership interest where there would be gain if the position were sold, assigned, or otherwise terminated at its FMV. "Position" means an interest, including a futures or forward contract, short sale, or option.

Straight Debt. A *straight debt* is any position with respect to a debt if the position unconditionally entitles the holder to receive a specified principal amount; interest payments are payable based on a fixed or variable rate, and the position cannot be converted (directly or indirectly) into stock of the issuer or any related person.

Offsetting Notional Principal Contract. An *offsetting notional principal contract* is an agreement that includes:

1. a requirement to pay all or substantially all of the investment yield (including appreciation) related to the property for a specified period and

2. a right to be reimbursed for all or substantially all of any decline in the value of the property.

Forward Contract. A *forward contract* is a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

Exceptions to the Constructive Sale Rules

Nonmarketable Securities If Sale Closed within One Year. A contract for the sale of any stock, debt instrument, or partnership interest is not a constructive sale if the contract is settled within one year after the date the contract is

entered into. This exception does not apply if the property is a marketable security (i.e., a security for which there is a market on an established securities market or otherwise).

Certain Sales Closed within 30 Days after the Close of the Tax Year. A contract for the sale of any stock, debt instrument, or partnership interest is not a constructive sale if (1) the transaction is closed before the end of the 30th day after the close of the tax year, (2) the taxpayer holds the appreciated financial position throughout the 60-day period beginning on the date the transaction is closed, and (3) at no time during the 60-day period in Item 2 is the taxpayer's risk of loss relating to the appreciated financial position reduced by reason of positions held for substantially similar or related property.

SELF-STUDY QUIZ

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

7. Certain losses on an original investment in Section 1244 stock are treated as ordinary losses instead of capital losses. Section 1244 stock is stock issued by a small business corporation. What is the maximum amount of money and other property that a corporation may receive for its stock, contributions to capital, and paid-in surplus and meet the definition of a small business corporation?

   a. $1,000,000.

   b. $500,000.

   c. $100,000.

   d. $50,000.

8. In certain situations, a taxpayer may recognize a capital loss when a security held as a capital asset declines in value. Which of the following events would justify a capital loss deduction for a decline in value?

   a. A company declares bankruptcy during the year even though the company expects to continue operations.

   b. A security for the first time has no liquidation value and no reasonable hope or expectation of becoming valuable at some future date.

   c. The market price of a security held by a taxpayer as a capital asset declines 80% during the year.

   d. A company that has historically paid significant dividends announces that no dividends will be paid during the current year.

9. On July 1, John paid Jennifer $300 for a 90-day put option that gave John the right to sell 100 shares of Alliance, Inc. stock for $30,000. The stock price for Alliance declines, and John exercises the put option. What is Jennifer's tax basis in the 100 shares of Alliance?

   a. $30,300.

   b. $30,000.

   c. $29,700.

   d. $300.

10. On April 1, Andrew paid Amy $200 for a 180-day call option that gave Andrew the right to purchase 100 shares of Gold, Inc. stock for $20,000. The stock price for Gold increases, and Andrew exercises the call option. What is Andrew's tax basis in the 100 shares Gold?

    a. $200.

    b. $19,800.

    c. $20,000.

    d. $20,200.

11. A Section 1256 contract that is open at the end of the year is treated as having been sold for fair market value on the last business day of the tax year. The mark-to-market gains and losses are taken into account when the contract is subsequently disposed. Regardless of the holding period, the capital gains and losses on a Section 1256 contract are automatically treated as:

    a. 40% long-term and 60% short-term.

    b. 60% long-term and 40% short-term.

    c. Long-term if the holding period is more than one year and short-term if the holding period is one year or less.

    d. 50% long-term and 50% short-term.

12. Assuming that a taxpayer does not hold substantially identical property, when does the taxpayer report loss from a transaction involving a short sale of a security that has increased in price?

    a. When the taxpayer borrows the securities from a broker.

    b. When the borrowed securities are sold to a buyer.

    c. When the taxpayer purchases securities to replace the borrowed securities.

    d. When the securities purchased by the taxpayer are delivered to the broker to replace the borrowed securities.

13. Sherrie owns 100 shares of Flash, Inc. stock that she acquired on February 15 of Year 1 for $3,000. On January 15 of Year 2, Sherrie sells 100 shares of Flash stock short for $4,000. On May 1 of Year 2, Sherrie closes out the short sale by delivering the 100 shares of Flash stock that she had purchased on February 15 of the prior year. What is the amount and type of gain or loss that Sherrie recognizes on the short sale?

    a. $1,000 short-term capital gain.

    b. $1,000 short-term capital loss.

    c. $1,000 long-term capital gain.

    d. There is no short sale in this scenario because the property is not considered substantially identical.

14. Generally, a taxpayer is allowed capital gain treatment on the sale of stock received from the exercise of an incentive stock option unless the sale is a disqualifying disposition. When does a disqualifying disposition occur?

    a. When the taxpayer sells the stock within two years of the exercise date.

    b. When the taxpayer sells the stock within two years of the grant date or the exercise date.

    c. When the taxpayer sells the stock within two years of the grant date or one year of the exercise date.

15. Generally, a nonqualified stock option is not taxable to a taxpayer until exercised unless the fair market value of the option is readily ascertainable when the option is granted. All of the following are conditions that must be met for an option to have a readily ascertainable value if the option is not actively traded on an established market **except**—

    a. The option is transferable and exercisable immediately in full by the taxpayer.

    b. There are no restrictions on the option or the stock that have a significant effect on the fair market value of either.

    c. The fair market value of the option privilege can be determined by the value of the property subject to the option, probability of an increase or decrease in value, and length of the option period.

    d. The option must be nontransferable.

16. Special rules that provide for gain exclusion or deferral apply to taxpayers who sell qualified small business stock (QSBS). To qualify as QSBS, the stock must be originally issued after August 10, 1993. In addition, a limit is placed on the aggregate gross assets that a C corporation may own at any time from August 10, 1993, to immediately after the issuance of the stock. This limit is which of the following?

    a. $50 million.

    b. $10 million.

    c. $1 million.

17. On August 1, Calvin purchases 200 shares of TAB, Inc. stock for $1,000. Calvin sells these shares for $800 on October 1. Three weeks later on October 21, he purchases 100 shares of TAB stock for $500. What is Calvin's tax basis in the 100 shares acquired on October 21?

    a. $500.

    b. $700.

    c. $800.

    d. $1,000.

18. Any position relating to a debt instrument, stock, or partnership interest where there would be gain if the position were assigned, sold, or otherwise terminated at its fair market value is referred to as which of the following terms?

    a. Offsetting notional principal contract.

    b. Forward contract.

    c. Straight debt.

    d. Appreciated financial position.

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.)**

7. Certain losses on an original investment in Section 1244 stock are treated as ordinary losses instead of capital losses. Section 1244 stock is stock issued by a small business corporation. What is the maximum amount of money and other property that a corporation may receive for its stock, contributions to capital, and paid-in surplus and meet the definition of a small business corporation? **(Page 237)**

   a. $1,000,000. [This answer is correct. Under the Code, stock associated with the first $1 million of capital can qualify as Section 1244 stock. When total capital exceeds $1 million, the corporation may designate the Section 1244 shares issued in that year instead of a proportional allocation.]

   b. $500,000. [This answer is incorrect. The maximum amount of the limitation is more than $500,000. The maximum amount that a single taxpayer can claim as an ordinary loss on Section 1244 stock in a tax year is $50,000.]

   c. $100,000. [This answer is incorrect. The maximum amount of the limitation is more than $100,000. The maximum amount that a taxpayer filing a joint return can claim as an ordinary loss on Section 1244 stock in a tax year is $100,000.]

   d. $50,000. [This answer is incorrect. The maximum amount of the limitation is more than $50,000.]

8. In certain situations, a taxpayer may recognize a capital loss when a security held as a capital asset declines in value. Which of the following events would justify a capital loss deduction for a decline in value? **(Page 237)**

   a. A company declares bankruptcy during the year even though the company expects to continue operations. [This answer is incorrect. The filing of bankruptcy alone is not sufficient evidence that a security is totally worthless.]

   b. A security for the first time has no liquidation value and no reasonable hope or expectation of becoming valuable at some future date. [This answer is correct. According to the Code, taxpayers are allowed a capital loss for the year a security held as a capital asset becomes totally worthless.]

   c. The market price of a security held by a taxpayer as a capital asset declines 80% during the year. [This answer is incorrect. Capital losses for partial worthlessness cannot be claimed.]

   d. A company that has historically paid significant dividends announces that no dividends will be paid during the current year. [This answer is incorrect. A change in a company's dividend policy is not evidence that the security is worthless.]

9. On July 1, John paid Jennifer $300 for a 90-day put option that gave John the right to sell 100 shares of Alliance, Inc. stock for $30,000. The stock price for Alliance declines, and John exercises the put option. What is Jennifer's tax basis in the 100 shares of Alliance? **(Page 238)**

   a. $30,300. [This answer is incorrect. This is the amount of the premium paid for the option plus the price paid to purchase the stock.]

   b. $30,000. [This answer is incorrect. This amount represents the strike price of the stock that must be purchased.]

   c. $29,700. [This answer is correct. Under the Code, the writer's basis in the stock received is the option price for the stock less the premium received by the writer for granting the option.]

   d. $300. [This answer is incorrect. This amount is the premium paid for the put option.]

10. On April 1, Andrew paid Amy $200 for a 180-day call option that gave Andrew the right to purchase 100 shares of Gold, Inc. stock for $20,000. The stock price for Gold increases, and Andrew exercises the call option. What is Andrew's tax basis in the 100 shares Gold? **(Page 238)**

    a. $200. [This answer is incorrect. This amount is the cost of the option.]

    b. $19,800. [This answer is incorrect. This is the cost of the call option reduced by the basis of the stock acquired.]

    c. $20,000. [This answer is incorrect. This is the amount paid to acquire the stock.]

    d. $20,200. This answer is correct. Under the Code, the holder's basis in the stock is the sum of the cost of the option and the cost of the stock acquired.]

11. A Section 1256 contract that is open at the end of the year is treated as having been sold for fair market value on the last business day of the tax year. The mark-to-market gains and losses are taken into account when the contract is subsequently disposed. Regardless of the holding period, the capital gains and losses on a Section 1256 contract are automatically treated as: **(Page 238)**

    a. 40% long-term and 60% short-term. [This answer is incorrect. The percentages of long-term or short-term capital gain or loss for purposes of the mark-to-market requirement under Section 1256 contracts are not correctly stated.]

    b. 60% long-term and 40% short-term. [This answer is correct. IRC Sec. 1256 was enacted to curb abuse in the futures contract markets whereby taxpayers could accelerate the recognition of loss on a contract even though they held another contract with an offsetting but unrealized gain that would be recognizable in the future. Any gain or loss from a Section 1256 contract is automatically treated as 60% long-term and 40% short-term capital gain or loss.]

    c. Long-term if the holding period is more than one year and short-term if the holding period is one year or less. [This answer is incorrect. The holding period of the Section 1256 contract is not a factor in determining the character of the gain or loss.]

    d. 50% long-term and 50% short-term. [This answer is incorrect. The percentages of capital gain or loss are not correctly stated.]

12. Assuming that a taxpayer does not hold substantially identical property, when does the taxpayer report loss from a transaction involving a short sale of a security that has increased in price? **(Page 242)**

    a. When the taxpayer borrows the securities from a broker. [This answer is incorrect. A taxable event has not occurred.]

    b. When the borrowed securities are sold to a buyer. [This answer is incorrect. The short sale itself is not a taxable transaction.]

    c. When the taxpayer purchases securities to replace the borrowed securities. [This answer is incorrect. The short position is still open.]

    d. When the securities purchased by the taxpayer are delivered to the broker to replace the borrowed securities. [This answer is correct. Under the Code, a short sale becomes a taxable sale when the taxpayer closes the transaction.]

13. Sherrie owns 100 shares of Flash, Inc. stock that she acquired on February 15 of Year 1 for $3,000. On January 15 of Year 2, Sherrie sells 100 shares of Flash stock short for $4,000. On May 1 of Year 2, Sherrie closes out the short sale by delivering the 100 shares of Flash stock that she had purchased on February 15 of the prior year. What is the amount and type of gain or loss that Sherrie recognizes on the short sale? **(Page 242)**

a. $1,000 short-term capital gain. [This answer is correct. Under IRS Regulations, if, on the date of a short sale, substantially identical property has been held by the taxpayer for a period of one year or less, a gain on the short sale is a short-term capital gain regardless of how long the stock used to close the short sale has been held. In this example, the period between the acquisition of the stock (February 15) and the short sale (January 15) is less than one year.]

b. $1,000 short-term capital loss. [This answer is incorrect. According to the rules for short sales in IRC Sec. 1233, a loss would not be recognized on the transaction.]

c. $1,000 long-term capital gain. [This answer is incorrect. The stock had been held for less than one year, so using the rules in IRC Sec. 1233, any gain or loss would not be considered long-term.]

d. There is no short sale in this scenario because the property is not considered substantially identical. [This answer is incorrect. According to the Code, the property in this scenario would be considered substantially identical, and a short sale has taken place.]

14. Generally, a taxpayer is allowed capital gain treatment on the sale of stock received from the exercise of an incentive stock option unless the sale is a disqualifying disposition. When does a disqualifying disposition occur? **(Page 244)**

a. When the taxpayer sells the stock within two years of the exercise date. [This answer is incorrect. This answer choice does not correctly describe the requirements that must be met before a disqualifying disposition occurs.]

b. When the taxpayer sells the stock within two years of the grant date or the exercise date. [This answer is incorrect. This answer choice does not include the correct number of years the taxpayer must hold the stock before capital gain treatment is allowed.]

c. When the taxpayer sells the stock within two years of the grant date or one year of the exercise date. [This answer is correct. Under the Internal Revenue Code, these are the characteristics of a disqualifying disposition. Instead of receiving capital gain treatment, the taxpayer must recognize ordinary income equal to the lesser of (1) the excess of the FMV of the stock on the exercise date over the exercise price paid, or (2) the excess of the amount realized from the disposition of the stock over the exercise price paid.]

15. Generally, a nonqualified stock option is not taxable to a taxpayer until exercised unless the fair market value of the option is readily ascertainable when the option is granted. All of the following are conditions that must be met for an option to have a readily ascertainable value if the option is not actively traded on an established market **except**— **(Page 244)**

a. The option is transferable and exercisable immediately in full by the taxpayer. [This answer is incorrect. These are two of the four conditions that must be met for the option to have a readily ascertainable value when not actively traded on an established market.]

b. There are no restrictions on the option or the stock that have a significant effect on the fair market value of either. [This answer is incorrect. For the option to have a readily ascertainable value when not actively traded on an established market this is one of the four conditions that must be met under the regulations.]

c. The fair market value of the option privilege can be determined by the value of the property subject to the option, probability of an increase or decrease in value, and length of the option period. [This answer is incorrect. This is one of the four conditions that must be met for the option to have a readily ascertainable value when not actively traded on an established market.]

d. The option must be nontransferable. [This is answer is correct. Under the IRS regulations, one of the conditions that must be met for the fair market value to be readily ascertainable is that the option is transferable. Thus, this answer is not a condition that must be met.]

16. Special rules that provide for gain exclusion or deferral apply to taxpayers who sell qualified small business stock (QSBS). To qualify as QSBS, the stock must be originally issued after August 10, 1993. In addition, a limit is placed on the aggregate gross assets that a C corporation may own at any time from August 10, 1993, to immediately after the issuance of the stock. This limit is which of the following? **(Page 247)**

    a. $50 million. [This answer is correct. This is the amount of gross assets allowed under the Code. In addition to the gross asset requirement, the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded.]

    b. $10 million. [This answer is incorrect. This amount is a limit used in determining the gain exclusion on the sale of QSBS.]

    c. $1 million. [This answer is incorrect. This amount is the maximum amount of money and other property that a corporation may receive for its stock, contributions to capital, and paid-in surplus and meet the definition of a *small business corporation*, which is unrelated to the term *qualified small business stock*.]

17. On August 1, Calvin purchases 200 shares of TAB, Inc. stock for $1,000. Calvin sells these shares for $800 on October 1. Three weeks later on October 21, he purchases 100 shares of TAB stock for $500. What is Calvin's tax basis in the 100 shares acquired on October 21? **(Page 249)**

    a. $500. [This answer is incorrect. This amount represents the sales price of the 100 shares purchased on October 21.]

    b. $700. [This answer is correct. The $200 loss ($1,000 − $800) on the sale of the 200 shares on October 1 is not deductible since Calvin purchased 100 shares of substantially identical stock within 30 days of the sale. Under the Code, this is considered a wash sale. The disallowed loss increases the basis of the stock acquired on October 21. The tax basis of the 100 shares is $700 ($500 + $200).]

    c. $800. [This answer is incorrect. This amount represents the sales price of the 200 shares on October 1.]

    d. $1,000. [This answer is incorrect. This amount represents the basis of the 200 shares acquired on August 1 and sold on October 1.]

18. Any position relating to a debt instrument, stock, or partnership interest where there would be gain if the position were assigned, sold, or otherwise terminated at its fair market value is referred to as which of the following terms? **(Page 249)**

    a. Offsetting notional principal contract. [This answer is incorrect. This term refers to an agreement that includes a requirement to pay all or substantially all of the investment yield related to the property for a specified period and a right to be reimbursed for all or substantially all of any decline in the value of the property.]

    b. Forward contract. [This answer is incorrect. This term refers to a contract to deliver a substantially fixed amount of property for a substantially fixed price.]

    c. Straight debt. [This answer is incorrect. This term refers to any position with respect to debt if the position unconditionally entitles the holder to receive a specified principal amount.]

    d. Appreciated financial position. [This answer is correct. Under IRC Sec. 1259, this is the definition of the term *appreciated financial position*. The constructive sale rules require recognition of gain (but not loss) for certain transactions involving an appreciated financial position.]

Investor versus Stock Trader

Taxpayers buying and selling securities for their own account generally will qualify as either an investor or trader for tax purposes. The distinction between trader and investor is important because the tax rules are generally more favorable for traders. As a general rule, most taxpayers are categorized as investors. However, in today's setting of online trading and discount brokers, some taxpayers are spending considerable time trading stocks on a regular basis, which may qualify them for trader status.

Taxation of Investors

Investors treat their stock holdings as capital assets and, when shares are sold, report either long-term or short-term capital gains or losses, depending on whether the shares were held for more than one year. The expenses they incur in connection with their stock investing activity are treated as Section 212 expenses incurred for the production of income. These expenses are deductible only as miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limitation. In addition, these expenses are not deductible in computing the taxpayer's alternative minimum tax (AMT). Any commissions paid in purchasing the securities are capitalized as part of its cost basis while commissions paid at the time of sale reduce the sales proceeds. Any interest expense incurred in the activity is deductible only to the extent of the taxpayer's net investment income.

The Tax Court has held that an investor cannot deduct the cost of a seminar in securities day trading. Jones had taken a Section 212(l) deduction for the course expenses. However, IRC Sec. 274(h)(7) denies a Section 212 deduction for "expenses allocable to a convention, seminar, or similar meeting." The court in *Jones* concluded that the day trading course was a "seminar or similar meeting" within the meaning of IRC Sec. 274(h)(7). The court observed that had Jones been a trader rather than an investor, the course expenses would have been deductible under Section 162.

Taxation of Traders

Unlike investors, securities traders are deemed to be conducting a trade or business, so their trading expenses are deductible as ordinary and necessary business expenses under IRC Sec. 162. A trader's business expenses include interest paid on margin accounts used in connection with the trading activity. However, if the taxpayer does not materially participate in the trading activity (e.g., a limited partner in a trader partnership), interest incurred in the activity is subject to the investment interest expense limitation. In addition, a trader's business status makes him eligible for claiming a home office deduction, provided the requirements of IRC Sec. 280A(c) are met. Individuals report their trading expenses (including interest on margin tax accounts) on Schedule C.

When a trader disposes of a stock, the general rule is that the sale is treated as a short-term or long-term capital gain or loss, depending on how long the stock was held. This capital asset treatment occurs because traders do not have customers to whom they sell stock; therefore, their stock does not meet any of the exceptions to capital asset treatment under IRC Sec. 1221. Thus, traders generally report their stock gains and losses as capital gains and losses on Schedule D and, accordingly, are subject to the $3,000 annual limitation that applies to net capital losses under IRC Sec. 1211(b) and the wash sale rules. The Section 1091 wash sale rules can be particularly detrimental to traders because they defer the recognition of a stock loss when the taxpayer acquires the same stock within a period beginning 30 days before and ending 30 days after the date of sale.

Mark-to-market Election. As an alternative to capital asset treatment, IRC Sec. 475(f) allows traders to elect to mark their stock holdings to market at the end of the tax year. If the election is made, all security gains and losses are treated as ordinary income and all securities on hand at year-end are deemed to be sold at the year-end market value, thus recognizing unrealized gains and losses. For traders, the primary benefit of making the election is that the $3,000 limitation on net capital losses and the wash sale rules no longer apply. Conversely, the trader is no longer allowed to treat trading activity gains and losses as capital asset transactions, but this should have minimal negative impact since traders by definition should have few, if any, long-term capital gains (see "Distinguishing Traders from Investors" later in this lesson).

Traders who choose to make the Section 475(f) mark-to-market election must follow the exclusive procedures set forth in Rev. Proc. 99-17. Existing taxpayers must (1) attach an election statement to either their timely filed return

or extension request for the year preceding the year the election is first effective, and (2) attach a completed Form 3115 "Application for Change in Accounting Method" to their return for the year of change, following the automatic IRS consent procedures described in Rev. Proc. 2008-52, as clarified, amplified, and modified by Rev. Proc. 2009-39. An election is effective for the tax year for which it is made and all subsequent tax years, unless revoked with the consent of the IRS.

Because capital gains and losses are specifically excluded from the definition of net earnings from self-employment (SE), earnings from a trading activity are not subject to the SE tax. A Section 475 mark-to-market election converting the gains and losses to ordinary income does not change their status for SE tax purposes. However, since a trader's net earnings are not SE income, he or she cannot contribute to a retirement plan (e.g., SEP or IRA) based on such income.

Tax Reporting Issues for Stock Traders. Because of the unique tax rules that apply to securities traders, properly reporting trading information on Form 1040 can be a challenge. Practitioners should consider the following reporting issues and recommended solutions:

1. *Schedule C Loss.* Traders who do not make a Section 475 election report no income and only expenses on Schedule C, resulting in a loss on that form. This reporting may get the IRS's attention since Schedule C losses sometimes stem from disallowable hobby losses. To help avoid IRS questions regarding this reporting, a footnote or statement explaining the taxpayer's trader status and the filing implications should be attached to the return.

2. *Reconciling to Forms 1099-B.* Because traders report their security sales on Schedule D, the amounts reported to them on brokers' Forms 1099-B will normally agree with the reported gross proceeds. However, traders who make the Section 475 election treat their trading gains and losses as ordinary income reported on Form 4797 (Part II). The Form 4797 instructions state that these traders should enter the total gross proceeds from Forms 1099-B on line 1 of Form 4797. To further help avoid IRS matching notices with respect to the Forms 1099-B, consider attaching a statement to the return explaining that the gross proceeds reported on the Forms 1099-B are not reported on Schedule D because they are reported on Form 4797 pursuant to a Section 475 mark-to-market election.

3. *Detailing Trading Activity.* Schedule D requires that each separate stock or security trade be reported separately. For traders, however, this can be a burdensome requirement given their large number of trades. In many cases, the taxpayer will have detailed records reporting each trade that can be attached to the return to support the amounts shown on Schedule D. The Form 4797 instructions state that traders who make the Section 475 mark-to-market election should attach a statement to the return detailing each trading transaction and carry the totals to line 10 of Form 4797.

Summary of Taxation Rules for Traders and Investors

Following is a summary of the tax treatment of investors and traders, including traders who make the Section 475 mark-to-market election.

Summary of Tax Attributes—Investors and Traders

	Investor	Trader	Mark-to-Market Trader
Gains and losses	Capital (Sch. D)	Capital (Sch. D)	Ordinary (Form 4797, Part II)
Interest expense	Investment interest expense (Form 4952)	Trade or business expense[a]	Trade or business expense[a]
Trading expenses	Miscellaneous itemized deductions subject to 2% AGI limitation (Sch. A)	Trade or business expenses (Sch. C)	Trade or business expense (Sch. C)
SE tax	Not applicable	Not applicable	Not applicable

Note:

[a] Assuming individual materially participates in the trading activity; if not, interest expense is investment interest expense.

Distinguishing Traders from Investors

There are no IRS guidelines on the distinction between a securities investor and a stock trader for tax purposes. The general presumption is that individuals hold stocks and securities as investors unless their actions demonstrate that they are carrying on a business of securities trading. The courts, however, have been more helpful by pointing out several factors to consider when evaluating whether an individual is an investor or a trader.

The Federal Court of Appeals and the Tax Court have used the following factors to determine whether an individual is a trader: (1) the taxpayer's investment intent; (2) the nature of the income to be derived from the activity; and (3) the frequency, extent, and regularity of the taxpayer's securities transactions. A taxpayer is a securities trader only when both of the following are true: (1) the taxpayer's trading activity is substantial; and (2) the taxpayer seeks to profit from short-term swings in the daily market movement, rather than to profit from the long-term holding of investments. Thus, it is important to look at such factors as the number of trades, the average holding period, the sources of income, and the taxpayer's ongoing involvement in the activity and the percentage of available trading days on which trading activity occurred.

The Tax Court considers the number of executed trades in a year and the amount of money involved in those trades when evaluating whether a taxpayer's activities are substantial. However, *Jamie* implies that the amount involved may be more important than the number of trades. In this case, the IRS agreed that the taxpayer was a trader even though he averaged only 84 trades each year over a three-year period, presumably because each sale averaged $67,190.

Ideally, trading should be regular and continuous rather than sporadic. Factors unrelated to securities trading may also bear on a court's decision. For example, in Cameron the taxpayer was collecting unemployment compensation while trading stocks. The Court observed that this helped undermine his argument that he was engaged in a trade or business.

Given that a trader has a short-term perspective, it would be reasonable to expect few, if any, long-term gains (i.e., stocks held more than one year). For example, in *Levin*, the taxpayer spent most of his working days engaged in making stock transactions and in performing his own research on companies to identify potentially attractive trades. The Court of Claims ruled he was a trader rather than an investor.

In contrast, in *Steffler*, the Tax Court assigned investor status to a taxpayer who claimed to have spent 40–60 hours per week on commodity trading activities over a three-year period. He conducted his activities under a firm name, had business cards, used a separate bank account, and did his own research using a computerized investment analysis system. Nonetheless, he lost his case because he actually traded only 5 to 12 days during each of the three years in question, bought only 16 to 44 contracts per year, and dealt in only five different commodities. Likewise, in *Chen*, the taxpayer had a great number of trades and appeared to be attempting to profit from daily market movements. However, this trading activity lasted only a few months. Because his activity was not continuous, the court found that the taxpayer was not a trader entitled to ordinary loss treatment and mark-to-market accounting. And finally, in *Estate of Yaeger*, the Second Circuit Court of Appeals focused mainly on the holding period. Although the taxpayer's trading activity was admittedly vigorous (over 2,000 transactions in a two-year period), he often held securities over a year and the shortest holding period was three months. The taxpayer was found to be an investor, not a trader.

Following is a summary of the factors from these and other cases that have been used to determine whether an individual is a trader or investor.

Characteristics of Traders and Investors

	Trader	Investor
Criteria for buying and selling stocks	Expected short-term swings in the market and stock price; stock selection based on technical factors.	A more long-term perspective; considers stock's income (dividends) and potential for long-term capital appreciation; stock selection based on fundamental factors.
Involvement	Substantial personal involvement; frequent, regular, and continuous; devotes considerable time to activity; a primary source of individual's income for meeting personal living expenses.	Active primarily on weekends or after-work hours; may rely on a broker or agent; has other primary sources of income for meeting personal living expenses. Relatively short periods of high-volume trading may occur.
Stock holding periods	Generally 30 days or fewer; few, if any, stocks held more than a year.	A mixture of long-term and short-term holding periods.
Frequency of trades	Daily or almost daily trading; average one or more trades each day; few periods without any activity.	Sporadic trading; no particular pattern to activity; may go for long periods without any activity.
Source of income	Short-term gains.	Interest, dividends, long-term gains.

Can an Individual Be Both a Trader and an Investor? There is nothing to prevent an individual who qualifies as a trader to also hold stocks and securities for investment. However, it is important for the individual to clearly designate which securities are held for trading and which are held for investment. The authors believe this is best accomplished by using separate accounts for investment and trading activity. Alternatively, meeting the identification requirements for traders who elect to mark securities to market (see below) should suffice for traders who do not make the mark to market election. However, these requirements may be onerous, and non-electing traders are not explicitly required to meet them.

A trader who makes the Section 475 mark-to-market election must clearly identify a security as not held for trading before the close of the day on which it was acquired, originated, or entered into. When substantially similar securities are held for trading and investing, the trader must hold the investment securities in a separate, nontrading account maintained with a third party.

SELF-STUDY QUIZ

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

19. Taxpayers are allowed to deduct their expenses in connection with their stock investing activities. How do taxpayers who qualify as securities traders classify these deductions on their income tax returns?

    a. Ordinary and necessary business expenses.

    b. Miscellaneous itemized deductions subject to the 2% AGI limitation.

    c. Long-term capital losses.

    d. Short-term capital losses.

20. Traders can elect to mark their stock holdings to market at the end of each tax year. What is the primary benefit of making this election?

    a. The capital gain and loss rules apply.

    b. The wash sale rules apply.

    c. The $3,000 limitation on capital losses and the wash sale rules no longer apply.

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.)**

19. Taxpayers are allowed to deduct their expenses in connection with their stock investing activities. How do taxpayers who qualify as securities traders classify these deductions on their income tax returns? **(Page 260)**

    a. Ordinary and necessary business expenses. [This answer is correct. According to several court cases, this definition is allowable under IRC Sec. 162. The trader status allows the taxpayer to avoid having the expense be subject to the 2% AGI limitation. The ordinary and necessary business expenses are reported on Schedule C.]

    b. Miscellaneous itemized deductions subject to the 2% AGI limitation. [This answer is incorrect. A taxpayer categorized as an investor must report their investment expenses as miscellaneous itemized deductions.]

    c. Long-term capital losses. [This answer is incorrect. The expenses incurred by a trader would have a different tax classification than that of long-term losses.]

    d. Short-term capital losses. [This answer is incorrect. Although a securities trader may incur short-term capital losses, the expenses incurred by a trader are different from any short-term capital losses incurred, and thus would be classified separately on the tax return.]

20. Traders can elect to mark their stock holdings to market at the end of each tax year. What is the primary benefit of making this election? **(Page 260)**

    a. The capital gain and loss rules apply. (This answer is incorrect. When the mark-to-market election is made, the trader is no longer allowed to treat the securities as capital assets.]

    b. The wash sale rules apply. [This answer is incorrect. When the mark-to-market election is made, the trader no longer has to apply the wash sale rules.]

    c. The $3,000 limitation on capital losses and the wash sale rules no longer apply. [This answer is correct. If the election is made under IRC Sec 475(F), all security gains and losses are treated as ordinary income and all securities on hand at year-end are deemed to be sold at the year-end market value.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TDBTG093)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. What is the required holding period of stock that is a capital asset to receive long-term tax treatment?

   a. One year.

   b. More than one year.

   c. Less than one year.

   d. More than six months.

2. Of the following types of property, which one would generally be considered a capital asset?

   a. Securities unless held by a dealer.

   b. Business accounts or notes receivable.

   c. Depreciable or real property used in the taxpayer's trade or business.

   d. Inventory.

3. Individual taxpayers are allowed to deduct up to $3,000 capital losses against ordinary income. To which years are the excess capital losses carried to first?

   a. Carried back three years.

   b. Carried back two years.

   c. No carryback or carryover is allowed.

   d. Carried forward indefinitely.

4. The capital loss carryover is the amount that a taxpayer's total net capital loss for the year exceeds the lesser of the taxpayer's allowable capital loss deduction for the year or adjusted taxable income for the year. "Adjusted taxable income" is taxable income increased for which of the following deductions?

   a. Capital loss deduction and standard deduction.

   b. Standard deduction and personal exemption deduction.

   c. Business loss deduction and capital loss deduction.

   d. Capital loss deduction and personal exemption deduction.

5. When an individual sells, exchanges, or redeems mutual fund shares, the amount of gain or loss is reported on which of the following Form 1040?

   a. Schedule A.

   b. Schedule B.

   c. Schedule D.

   d. Schedule E.

6. On March 1, 2008, Joe purchased 100 shares of a mutual fund, Momentum Growth Fund, for $5,000. The load charge for the purchase was $200. At the beginning of the following year, Joe receives a 2008 Form 1099-DIV from the mutual fund that reports $100 of dividends and $300 of long-term capital gains, both of which have been reinvested. Joe sells his 100 mutual fund shares on August 1, 2010 for $6,000. What is the amount and character of the gain or loss that Joe recognizes on the transaction?

   a. $1,000 long-term capital gain.

   b. $1,400 long-term capital gain.

   c. $600 long-term capital gain.

   d. $400 long-term capital gain.

7. What is the maximum amount of ordinary loss on Section 1244 stock that may be claimed by a taxpayer filing a joint return in a tax year?

   a. $500,000.

   b. $100,000.

   c. $50,000.

   d. $10,000.

8. The statute of limitations for losses from worthless securities is which of the following?

   a. Two years.

   b. Three years.

   c. Four years.

   d. Seven years.

9. An option that is publicly traded and gives the option holder the right to sell to the option writer a stated number of shares of stock at a fixed price on or before a specified date is which of the following?

   a. Section 1256 contract.

   b. Call option.

   c. Put option.

   d. Incentive stock option.

10. An option that is publicly traded and gives the option holder the right to buy from the option writer a stated number of shares of stock at a fixed price on or before a specified date is which of the following?

    a. Call option.

    b. Put option.

    c. Nonqualified stock option.

    d. Equity option.

11. Within certain limits, how many years can a taxpayer elect to carryback a net Section 1256 loss?

    a. None.

    b. Two.

    c. Three.

    d. Five.

12. Generally, what is the economic purpose of a short sale?

    a. To profit from an increase in the price of a stock.

    b. To profit from a decline in the price of a stock.

    c. To create capital losses.

    d. To convert short-term gains into long-term gains.

13. Steve does not own any stock in ACE, Inc. but borrows 500 shares of ACE stock from his broker on June 1 and sells it short for $10,000 ($20 a share). On September 1 of the following year, Steve purchases 500 shares of ACE stock for $7,500 ($15 a share) and delivers them to his broker to close the short sale. What is the amount and type of gain or loss that Steve recognizes on his short sale?

    a. $2,500 long-term capital gain.

    b. $2,500 long-term capital loss.

    c. $2,500 short-term capital gain.

    d. $2,500 short-term capital loss.

14. After an employee's termination, how long does the employee generally have to exercise an incentive stock option before it expires?

    a. Thirty days.

    b. Twelve months.

    c. Two years.

    d. Three months.

15. Katherine received a NQSO from OceanView, Inc., her employer, on July 1, 2008, that entitled her to purchase 1,000 shares of OceanView at $10 per share. The option did not have a readily ascertainable value. OceanView used a reasonable method to determine that the exercise price was the fair market value on the grant date and, thus, was not subject to IRC Sec. 409A. Katherine exercised the option on September 30, 2009, when the stock was trading at $15 per share. What is the amount of compensation income that Katherine must recognize and in what year?

    a. $10,000 compensation income in 2008.

    b. $15,000 compensation income in 2009.

    c. $5,000 compensation income in 2009.

    d. $5,000 compensation income in 2008.

16. Noncorporate taxpayers are allowed to elect to rollover gain from the sale of small business stock (QSBS) held for more than six months if stock in another QSBS is acquired within a certain time period beginning on the date of the sale. What is this time period?

    a. 60 days.

    b. 90 days.

    c. 180 days.

    d. 12 months.

17. A taxpayer cannot deduct the loss realized on the sale of stock or securities if the taxpayer purchases substantially identical stock or securities within the period beginning 30 days before and ending 30 days after the sale. The term used to describe this type of transaction is which of the following?

    a. Straddle sales.

    b. Constructive sales.

    c. Wash sales.

    d. Short sales.

18. An exception to the constructive sale rules applies to sales of nonmarketable securities if the sales contract is settled within a certain period after the date the contract is entered into. This time period is which of the following?

    a. Within thirty days.

    b. Within sixty days.

    c. Within six months.

    d. Within one year.

19. Taxpayers who qualify as stock traders and elect to mark their stock holdings to market at the end of each year must recognize security gains and losses as which of the following?

    a. Ordinary income and losses.

    b. Capital gains and losses.

    c. Miscellaneous itemized deductions.

    d. Do not select this answer choice.

20. The Federal Circuit Court of Appeals and the Tax Court identified certain factors that determine if an individual is a trader. Which of the following was **not** one of these factors?

    a. The extent, frequency, and regularity of the taxpayer's securities transactions.

    b. The nature of any income that will be derived from the activity.

    c. The investment intent of the tax payer.

    d. More long-term transactions than short-term transactions.

Lesson 2: Bad Debt Losses, Debt Discharge Income, and Foreclosures

INTRODUCTION

Transactions involving bad debt losses, debt discharges, and foreclosures are relatively common for individual taxpayers. This lesson covers the rules for deducting bad debt losses and explains the tax treatments of debt discharge income and foreclosures.

Banks, other financial institutions, and certain government agencies generally must report debt discharges (partial or complete) on Form 1099-C (Cancellation of Debt) if the discharge is $600 or more. The discharged amount includes any amount owed to the lender that is forgiven, including loan principal, interest, penalties, administrative costs, and fines. To determine the year in which a debt is discharged, the lender must identify an event (e.g., bankruptcy of debtor, running of statute of limitations for debt collection, nonpayment for a 36-month period, cessation of collection activities, etc.) indicating the debtor will never have to pay the amount that is discharged (considering all the facts and circumstances). Sometimes the lender will issue Form 1099-C for the wrong year. For example, in *DeShon*, the taxpayer received a 1099-C for 2001. However, the Tax Court determined that the debt discharge event actually occurred in 1999, when the credit card lender ceased collection activities. Since 1999 was a closed year, the taxpayer did not have to recognize taxable debt discharge income with respect to that particular credit card debt.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:

- Differentiate between business and nonbusiness bad debts.
- Identify the rules of debt discharge income for a solvent taxpayer and an insolvent taxpayer and make relevant calculations.
- Identify the tax rules for foreclosures involving recourse, nonrecourse, and seller-financed debt.

Business and Nonbusiness Bad Debts

Individual taxpayers can deduct two types of bad debt losses: business and nonbusiness. Business bad debts result in ordinary losses; nonbusiness bad debts result in short-term capital losses. This distribution has been the subject of much litigation due to the $3,000 annual limit on deducting net capital losses ($1,500 for married taxpayers who file separately).

Business Bad Debts

A business bad debt arises from:

1. a debt created or acquired in the ordinary course of the taxpayer's business (e.g., an account receivable), or

2. a worthless debt, the loss from which is incurred in the taxpayer's trade or business.

Item 2 is the most frequently contested, and often occurs when a shareholder or employee loans funds to a corporation and claims a business bad debt deduction when the loan becomes either wholly or partially worthless. (See "Employee versus Shareholder Loans" later in this lesson.)

Trade or Business Requirement. In determining whether a bad debt loss was incurred in the taxpayer's trade or business, the focus is on the relation the loss bears to the taxpayer's business. If at the time of total or partial worthlessness, the relation is "proximate" in the conduct of the trade or business, the debt qualifies as a business bad debt. The Supreme Court, in *Generes*, stated that in determining whether the relation is proximate, the *dominant motivation* for making the loan must be business oriented. A significant motivation does not satisfy this requirement.

A business debt usually is made in the course of the lender's own trade or business, as opposed to a loan to another business. However, the taxpayer may establish that a loan to another business is a business loan if it was made (1) as part of the taxpayer's business of making loans or of promoting businesses, or (2) to protect the taxpayer's status as an employee, source of income, business relationship, or business reputation. For example, in *Newsman*, the Tax Court concluded the taxpayer's substantial and recurring activities of promoting, organizing, financing, and selling various businesses constituted a trade or business. Therefore, the taxpayer's losses from loans advanced to the businesses and from guarantees of the businesses' loans qualified as business bad debt losses.

In Field Service Advice (FSA) 199911003, the IRS examined the factors for determining whether a taxpayer's lending of money qualifies as a trade or business. The IRS concluded the taxpayer could deduct the uncollectible amount of a note he had purchased as a business bad debt. The IRS found that the taxpayer was in the trade or business of lending money since he had loaned money and purchased notes for many years, had a reputation in the community as a lender and purchaser of notes, had been approached by unrelated borrowers and sellers of notes, and had taken action to enforce his rights under the note. Thus, the taxpayer's actions were consistent with an individual engaged in the money lending business.

The taxpayer's overall accounting method may affect whether a bad debt is deductible, even if it arises in the course of a trade or business. Thus, if the bad debt arose from an unpaid item of taxable income (e.g., account receivable for services rendered), a bad debt deduction is not allowed unless the related income was included in taxable income in either the current or prior tax year. For cash-basis taxpayers, a bad debt deduction is generally not allowed for uncollectible accounts receivable since these items are normally not included in income until received.

Partial versus Total Worthless Debt. A deduction can be claimed when a business bad debt becomes either partially or totally worthless. If the taxpayer can collect some, but not all, of the debt, the debt is partially worthless. If the taxpayer cannot collect any of the outstanding debt (even if part was collected in the past), the debt is totally worthless.

Before a taxpayer can deduct a partially worthless business debt, he must show that (1) partial worthlessness has occurred and (2) the amount was charged off on the books of the business. For tax purposes, the taxpayer has the following options:

1. Claim a deduction for any portion of the debt, up to the amount actually written off the books during the year. (For example, if EasyCredit, an accrual-basis sole proprietorship, wrote off $10,000 of a $30,000 receivable due from Thrift Co. for book purposes, the taxpayer can claim a current-year bad debt deduction for any amount up to and including $10,000.) Recording a book charge-off requires that the portion charged off must no longer appear as an asset in the business's financial records or on its financial statements. However, it does not mean the business must cancel the debt or notify the debtor of the charge-off. Thus, the taxpayer may still continue its collection efforts while claiming a tax deduction for a partially worthless debt.

2. Forgo a current-year tax deduction in favor of waiting until the balance of the debt is either collected or deemed worthless to claim a bad debt deduction.

The taxpayer can treat each partially worthless debt differently. However, in no case can a deduction be claimed any later than the year a debt becomes completely worthless.

A totally worthless debt is deductible only in the tax year it becomes totally worthless. Naturally, the deduction for that year does not include any amount deducted in an earlier year when the debt was only partially worthless.

Employee versus Shareholder Loans. In *Litwin*, the 10th Circuit allowed an employee-shareholder's business bad debt deduction for amounts loaned to the corporation. The deduction was allowed because the taxpayer's predominant motives for making the loans were that he (1) wanted to remain employed, earn a salary, and remain useful to society; (2) spent a large portion of his time working for the corporation; (3) intended to draw a salary in the future; and (4) took a sizable risk when he guaranteed loans far in excess of the value of his investment (indicating there

was another motive besides investment). Although the taxpayer's loans were much larger than the salary anticipated in the near future, the Court ruled his business motives outweighed his investment motives.

In contrast, the 7th Circuit ruled that a taxpayer's advances to a controlled corporation did not result in business bad debts. The taxpayer received no compensation from the corporation and was not considered to be in the business of loaning money, nor was he in the business of selling corporations he owned. Thus, when a taxpayer's predominant motivation for making loans is to protect his investment as a shareholder, nonbusiness bad debt status generally applies. *Mills* and *Scallen* illustrate situations in which the courts have ruled shareholders should be denied business bad debt deductions.

Loans versus Capital Contributions. The first step in analyzing a shareholder loan (for bad debt deduction purposes) is determining whether the advance is a valid debt as opposed to a capital contribution. Factors used in deciding whether payments by a shareholder to a corporation are debt or equity include (1) the name given to the certificate evidencing the indebtedness, (2) whether a fixed maturity date exists, (3) whether the party providing the funds can enforce payment, (4) the source of the payments, (5) whether the party providing the funds is given an increased participation in management, (6) the intent of the parties, (7) whether the corporation is adequately capitalized, (8) whether interest is paid, (9) whether the corporation can obtain loans from outside lenders, (10) the extent to which the corporation uses the advance to acquire capital assets, (11) whether shareholders provide funds in proportion to their stock interests, (12) whether the business repaid the amount advanced when due, and (13) whether the business's obligation to repay the advance is subordinated to other creditors.

In *Nachman*, a 50% shareholder-employee was allowed a business bad debt deduction for funds advanced to the corporation. The advance was treated as a loan because it (1) provided for payment of interest and the shareholder reported interest income on his return, (2) did not increase the shareholder's participation in management, and (3) was treated as a loan on the corporate books and tax returns. In addition, the corporation was adequately capitalized and used the funds for working capital. The loan met the trade or business requirement because the motivation for making the loan was to protect the corporation's line of credit. The bank required the shareholder to provide working capital to the corporation in return for continued financing.

Conversely, in *Kadlec*, an 80% shareholder was denied a bad debt deduction for funds advanced to the corporation; the funds were deemed to be a capital contribution. Although the shareholder received a note from the corporation, the factors indicating that the advance was actually a capital contribution were (1) the corporation could not obtain other financing, (2) the loan repayments were to be made from corporate profits, (3) the corporation was thinly capitalized, and (4) no interest payments were made on the note.

In *Bell*, the 8th Circuit upheld the Tax Court's denial of a business bad debt deduction for purported loans, which the Court characterized as capital contributions. The taxpayer made the purported loans to two corporations that he purchased to rehabilitate and resell. Moreover, he provided no personal services to the corporation. The purported loans were made to provide capital and thus were related to the taxpayer's role as shareholder of the corporations.

In *Indmar Products*, the Sixth Circuit ruled that the shareholders' cash advances to their closely held C corporation were debt rather than equity based on the following 11 factors.

1. *Descriptions on Documents.* If shareholder advances are not described as loans payable on the corporation's books and as loans receivable in the shareholder's financial records, the case is weakened for treating shareholder advances as debt.

2. *Maturity Date and Repayment Schedule.* The presence of a fixed maturity date and defined schedule of payments indicates debt. Actual repayments of purported debt principal amounts are very persuasive in making the case that shareholder advances are legitimate debt. However, fixed maturity dates and repayment schedules are not required for demand loans (payable at any time upon the demand of the shareholder-lender).

3. *Interest Rate and Payments.* The presence of a fixed rate of interest and the presence of actual interest payments indicate debt. Actual timely payments of fixed-rate interest persuasively make the case that shareholder advances are legitimate debt.

4. *Source of Repayment Funds.* The Sixth Circuit opined that relying on company profits to generate cash to repay loans is more characteristic of equity. However, in the real world, operating profits are often expected to be the main (if not the only) source of funds to repay even unquestionably legitimate third-party loans.

5. *Debt-to-Equity Ratio.* An excessively high debt-to-equity ratio indicates that shareholder advances may be equity. However, this factor is basically moot when the corporation demonstrates a pattern of repaying purported debt amounts along with appropriate interest.

6. *Overlap Between Shareholders and Lenders.* Purported loans made by shareholders strictly in proportion to their stock ownership interests indicate equity, unless there is only one shareholder.

7. *Security.* A lack of adequate security indicates equity.

8. *Availability of Debt Financing from Outside Sources.* When a corporation is demonstrably able to obtain third-party debt financing if it wishes, purported shareholder loans are more likely to be legitimate debt.

9. *Subordination.* Subordination of purported shareholder loans to all debt owed to third-party creditors is indicative of equity.

10. *Use of Proceeds.* Using the proceeds from shareholder advances to acquire long-term capital assets indicates equity, while using the proceeds for working capital indicates debt. In the real world, however, corporations commonly take out unquestionably legitimate third-party loans to acquire capital assets.

11. *Sinking Fund.* The Sixth Circuit opined that the existence of a sinking fund indicates debt. However, the existence of a sinking fund is actually just another form of security, and the security factor was already taken into account in item 7 above. Also, in the real world, many closely held corporations will be unwilling to establish sinking funds even for unquestionably legitimate third-party debt.

Tax Return Presentation. A business bad debt gives rise to an ordinary loss deduction. Report a bad debt arises in the ordinary course of an individual's unincorporated business (i.e., accounts receivable) on Schedule C or F, whichever is applicable. Report a bad debt that is the result of an employee-shareholder loan to a corporation as an unreimbursed employee business expense (subject to the 2% of AGI limit) on Schedule A of Form 1040 (IRS Pub. 529, "Miscellaneous Deductions"). It is important to remember that miscellaneous itemized deductions are added back to income when making the AMT calculation.

Example 2A-1 Business bad debt.

Ted runs his business as a sole proprietorship. He guaranteed payment of a $10,000 note of his best supplier in an effort to ensure the supplier continued in business. The supplier later filed bankruptcy and defaulted on the note. Ted was forced to make full payment under his guarantee. His efforts to recover from the supplier proved unsuccessful. What is the nature of Ted's $10,000 bad debt loss?

Ted's loss is a business bad debt loss since his guarantee was spurred by his business motive to retain his best supplier. The bad debt loss is claimed on Ted's Schedule C.

Variation: Assume that Ted is an employee of his solely owned C or S corporation. In this case, the business bad debt deduction should be reported as unreimbursed employee business expense on Schedule A.

Nonbusiness Bad Debts

Bad debts that are not business bad debts are nonbusiness bad debts (assuming they are not actually gifts). A nonbusiness bad debt is deductible as a short-term capital loss only in the year it becomes totally worthless. A deduction for partial worthlessness of a nonbusiness debt is not allowed.

Timing of Nonbusiness Bad Debt Loss. Because of the difficulties in pinpointing the year a loan becomes wholly worthless, the normal three-year statute of limitations for filing amended returns does not apply to nonbusiness bad debt losses. Instead, a seven-year statute of limitations generally applies for refunds due to such losses.

The lender is not required to wait until the debt is due to determine it is worthless. The debt becomes worthless in the year when it becomes clear there is no chance of repayment. Bankruptcy of the debtor is generally good

evidence that an unsecured or nonpreferred debt is worthless. However, in most cases, worthlessness exists only after the debt is due and collection efforts have begun. The lender must show that reasonable steps were taken to collect the debt.

Tax Return Presentation. A nonbusiness bad debt is deducted as a short-term capital loss on Schedule D (subject to the normal limitations on short-term capital losses). If there is more than one nonbusiness bad debt deduction in the tax year, list each bad debt separately on Schedule D. A statement should also be attached to the tax return to document each nonbusiness bad debt. The following information should be included (IRS Pub. 17, "Your Federal Income Tax"): (1) a description of the debt, including the amount and due date; (2) the debtor's name and relationship to the taxpayer; (3) the collection efforts made; and (4) why the debt is considered wholly worthless.

Example 2A-2 Nonbusiness bad debt.

In January 2009, John, an attorney, made a personal unsecured loan of $5,000, due October 1, 2009 to Peter, a client. On September 1, 2009, Peter declared bankruptcy; the debt became totally worthless. Although Peter was a valued client, his business was not critical to the success of John's practice.

John can deduct the loss on Peter's bad debt as a nonbusiness bad debt. Since John is not in the business of lending money and no overriding business reason existed for him to make the loan, the debt is nonbusiness. The loss is reported as a short-term capital loss on Schedule D.

Variation: If the loan only became partially worthless in 2009, no portion of the loss would be deductible that year because it is a nonbusiness bad debt.

Intrafamily Loans

Bad debts resulting from loans between family members are subject to close scrutiny, and are generally presumed to be gifts unless it can be established that a bona fide loan exists. If a bona fide loan exists, a bad debt deduction is possible if the borrower defaults. To qualify as a bona fide loan, an advance must be made with a reasonable intention of noncontingent repayment. While no one factor is controlling, the courts review the intent of the parties and the existence of the following as evidence of a bona fide loan: (1) a note or other evidence of indebtedness; (2) interest being charged; (3) a fixed repayment schedule; (4) security or collateral; (5) a demand for repayment; (6) the parties' records, if any, reflecting the transaction as a loan; (7) any repayments made; and (8) the solvency of the borrower. Advances made after a family member becomes insolvent are deemed to be gifts since a reasonable expectation of repayment cannot exist when the advance is made.

Although these loan formalities help establish a debtor-creditor relationship, a bona fide debt can exist without them. In *Bowman*, the Tax Court allowed a taxpayer's nonbusiness bad debt deduction for money transferred to his daughter even though the only documentation was the notation "loan" on several of the checks. The Court found the taxpayer had a history of making similar loans to other family members and friends (which were repaid) and that his and his daughter's actions showed the requisite intent to establish a debtor-creditor relationship. However, the better the documentation, the better the chance of establishing the existence of a bona fide debt (and thus a bad debt deduction).

Example 2A-3 Bad debt loss from loan to relative.

Bowen loaned his son, Rocky, $3,000 to buy a car. Rocky was to pay Bowen $50 a month until the $3,000 was repaid. Rocky paid back $500 but was unable to repay the remaining $2,500, which was then forgiven by Bowen. There was no documentation of Bowen's loan to Rocky. Can Bowen deduct $2,500 as a nonbusiness bad debt?

Because the transaction was between relatives; had no business, profit, or investment motivation; and lacked evidence of being a bona fide debt, the forgiveness of the debt is considered a gift and not a bad debt loss. No deduction is allowed.

Loan Guarantees

To claim a bad debt loss deduction, a taxpayer making a payment on a loan guarantee that becomes unrecoverable (i.e., worthless) must be able to show that the guarantee was made in the course of his trade or business or in a transaction entered into with a profit motive. In addition, the taxpayer must receive reasonable consideration for entering into the guarantee agreement. For the guarantee of a nonfamily member's debt, consideration can be either direct (i.e., cash or other property) or indirect. Indirect consideration is determined in accordance with normal business practice and may, for example, be in the form of improved business relationships. For the guarantee of a

family member's debt, however, the consideration must be direct (i.e., cash or other property). Here, the term *family member* is defined very broadly (e.g., the term includes in-laws and step-relationships) and includes all individuals listed in IRC Sec. 152(a) relating to the dependency exemption.

When payment is made under a loan guarantee, the taxpayer usually assumes the role of the original lender. Thus, payment under the guarantee generally gives the guarantor the right to, in turn, demand payment from the borrower. The guarantor, therefore, cannot claim a bad debt loss until reasonable collection efforts against the borrower have failed. This often means a bad debt loss will not be allowable in the same year payment under the guarantee occurs. Once collection efforts have failed, the guarantor has either a business or nonbusiness bad debt loss (or a gift) depending on the facts and circumstances of the original guarantee transaction.

Example 2A-4 Paying on guarantee of family member's loan.

Alfred retired from farming in 2005 and thereafter began leasing his farmland to his son, Michael, who continued working the farm. Alfred had dealt with First National Bank (FNB) for many years. When Michael secured a farm loan from FNB, Alfred agreed to guarantee it to assist Michael and to ensure a continued good relationship with FNB. In 2009, Michael quit farming because of ongoing losses and, therefore, was unable to repay the balance of the FNB loan. Under the terms of the guarantee, Alfred paid FNB $110,000. Based on Michael's financial situation, Alfred will not be able to recover any of the funds from Michael.

Alfred cannot claim a $110,000 nonbusiness bad debt. Since Michael is a family member, Alfred can claim a nonbusiness bad debt for paying on the loan guarantee only if he had received from Michael cash or other property as consideration for his guarantee. Alfred received neither, so the $110,000 payment is not deductible.

Note: Alfred may also be deemed to have made a $110,000 gift to Michael, which must be reported for gift tax purposes. However, Alfred may be able to argue there was no gift because there was no donative intent. Instead, since Michael is insolvent and unable to repay the loan, it is a bad debt to Alfred, but it is not deductible because the requirements are not met for deducting bad debts associated with loan guarantees for family members. If the payment is not deemed to be a gift, Michael will have discharge of indebtedness income (see the discussion later in this lesson on the handling of discharge of indebtedness income).

Recoveries of Bad Debts

A taxpayer who deducts a bad debt and subsequently recovers (collects) all or part of the debt must include the amount recovered in income. However, the amount includable in income is subject to the tax benefit rule. The recovery is included in income only to the extent the original deduction provided a tax benefit. If a deduction gave rise to a net operating loss carryover or capital loss carryover that has not expired before the beginning of the tax year in which the recovery occurs, the deduction will be treated as having provided a tax benefit.

Presumably, the character of the income recognized because of a recovery is the same as that of the originally claimed bad debt deduction. Thus, the recovery of a business bad debt normally generates ordinary income while a nonbusiness bad debt recovery is treated as short-term capital gain.

SELF-STUDY QUIZ

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

21. A business bad debt would generally **not** arise from which of the following transactions?

    a. An account receivable for services created in the ordinary course of the taxpayer's consulting business.

    b. A loan to a corporation made by a shareholder-employee when it can be demonstrated that the advance is valid debt.

    c. A loan to a business owned by the taxpayer's friend when the taxpayer is not in the business of making loans.

    d. A note receivable for funds advanced to a customer by a mortgage company.

22. A taxpayer has determined that an account receivable from the sale of inventory will not be fully collected. Of the following, which is **not** a consideration in determining if the taxpayer is allowed a business bad debt deduction?

    a. The taxpayer's overall accounting method.

    b. Partial worthlessness has occurred.

    c. The business has taken a charge-off on its books for the bad debt.

    d. The debt must be totally worthless to claim a business bad debt deduction.

23. Of the following factors, which group of factors would support a capital contribution instead of a business bad debt deduction for an advance to a corporation by a shareholder-employee?

    a. The debt is recorded on the corporation's financials; interest payments are made; and the shareholder's role in management does not increase.

    b. The documents describe the advance as debt; there is a fixed maturity date; the corporation is adequately capitalized; and the funds are used for working capital.

    c. A corporation cannot obtain other financing, is thinly capitalized, and does not make interest payments on the note.

24. In February 2008, Freda, a firefighter, made a personal unsecured loan of $5,000 to her friend, Frank. The loan, which is due February 2010, requires monthly payments to Freda. In August 2008, Frank begins paying less than the required monthly payment, and it appears that Freda will not be entirely repaid. In 2009, Frank declares bankruptcy, and the remaining balance on the debt is worthless. In what year is Freda allowed to recognize a bad debt deduction?

    a. 2008.

    b. 2009.

    c. 2010.

    d. Never.

25. Factors that the courts may review in determining if a bona fide loan (as opposed to a gift) exists between family members include all of the following **except** which factor?

    a. Fixed payment schedule that includes interest payments.

    b. The parties' records reflecting the transaction as a loan.

    c. The solvency of the borrower.

    d. How often the family members see each other.

26. Mr. Richard Generous agrees to be the loan guarantor to a business associate, Mr. Humble Loveable. Mr. Generous and Mr. Loveable are not related. Mr. Loveable is unable to make the fourteenth loan payment and calls Mr. Generous to make the payment under the loan guarantee. Mr. Loveable is subsequently unable to make any remaining payments under the terms of the loan agreement, and Mr. Generous makes all the remaining payments. When will Mr. Generous be able to write off his guarantee payments as a bad debt loss?

    a. After reasonable collection efforts against Mr. Loveable have failed.

    b. Monthly as each guarantee payment is made.

    c. The year the guarantee is written.

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.)**

21. A business bad debt would generally **not** arise from which of the following transactions? **(Page 271)**

    a. An account receivable for services created in the ordinary course of the taxpayer's consulting business. [This answer is incorrect. The dominant motivation for the existence of the account receivable is business oriented.]

    b. A loan to a corporation made by a shareholder-employee when it can be demonstrated that the advance is valid debt. [This answer is incorrect. The IRS frequently contests this type of deduction. Certain factors must exist for the advance to be considered debt instead of a capital contribution.]

    c. A loan to a business owned by the taxpayer's friend when the taxpayer is not in the business of making loans. [This answer is correct. Under the Internal Revenue Code, a business debt is usually made in the course of the lender's own trade or business, as opposed to a loan to another business.]

    d. A note receivable for funds advanced to a customer by a mortgage company. [This answer is incorrect. In this situation, the loss is proximate to the taxpayer's business of mortgage lending.]

22. A taxpayer has determined that an account receivable from the sale of inventory will not be fully collected. Of the following, which is **not** a consideration in determining if the taxpayer is allowed a business bad debt deduction? **(Page 271)**

    a. The taxpayer's overall accounting method. [This answer is incorrect. For cash-basis taxpayers, a bad debt deduction is generally not allowed for uncollectible accounts receivable since these items are normally not included in income until the cash is received.]

    b. Partial worthlessness has occurred. [This answer is incorrect. The taxpayer must show that partial worthlessness has occurred.]

    c. The business has taken a charge-off on its books for the bad debt. [This answer is incorrect. To claim a business bad debt deduction, the asset must no longer be reflected in the business's financial records.]

    d. The debt must be totally worthless to claim a business bad debt deduction. [This answer is correct. Under the IRS Regulations, total worthlessness is a requirement to claim a nonbusiness bad debt deduction, whereas partial wothlessness is allowed for a business bad debt deduction.]

23. Of the following factors, which group of factors would support a capital contribution instead of a business bad debt deduction for an advance to a corporation by a shareholder-employee? **(Page 271)**

    a. The debt is recorded on the corporation's financials; interest payments are made; and the shareholder's role in management does not increase. [This answer is incorrect. In *Nachman*, a 50% shareholder-employee was allowed a business bad debt deduction for funds advanced to the corporation when these factors were present.]

    b. The documents describe the advance as debt; there is a fixed maturity date; the corporation is adequately capitalized; and the funds are used for working capital. [This answer is incorrect. The presence of these factors would indicate that the funds are debt instead of equity.]

    c. A corporation cannot obtain other financing, is thinly capitalized, and does not make interest payments on the note. [This answer is correct. In *Kadlec*, an 80% shareholder was denied a bad debt deduction for funds advanced to the corporation because the funds were deemed to be a capital contribution.]

24. In February 2008, Freda, a firefighter, made a personal unsecured loan of $5,000 to her friend, Frank. The loan, which is due February 2010, requires monthly payments to Freda. In August 2008, Frank begins paying less than the required monthly payment, and it appears that Freda will not be entirely repaid. In 2009, Frank declares bankruptcy, and the remaining balance on the debt is worthless. In what year is Freda allowed to recognize a bad debt deduction? **(Page 271)**

    a. 2008. [This answer is incorrect. Although Frank was not making his full payments in 2008, a deduction for partial worthlessness is not allowed for a nonbusiness bad debt.]

    b. 2009. [This answer is correct. According to the Code, a nonbusiness bad debt is deductible only in the year it becomes totally worthless.]

    c. 2010. [This answer is incorrect. The lender is not required to wait until the debt is due to determine total worthlessness.]

    d. Never. [This answer is incorrect. A nonbusiness bad debt is deductible as a short-term capital loss once the appropriate timing is achieved under the Code.]

25. Factors that the courts may review in determining if a bona fide loan (as opposed to a gift) exists between family members include all of the following **except** which factor? **(Page 271)**

    a. Fixed payment schedule that includes interest payments. [This answer is incorrect. These factors support the existence of a loan instead of a gift.]

    b. The parties' records reflecting the transaction as a loan. [This answer is incorrect. The courts would review these records to determine the intent of the parties at the time the loan was made.]

    c. The solvency of the borrower. [This answer is incorrect. Advances made after a family member becomes insolvent are deemed to be gifts since a reasonable expectation of repayment cannot exist when the advance is made.]

    d. How often the family members see each other. [This answer is correct. The physical contact that the parties have with each other is not a relevant factor in the courts' reviews of such loans.]

26. Mr. Richard Generous agrees to be the loan guarantor to a business associate, Mr. Humble Loveable. Mr. Generous and Mr. Loveable are not related. Mr. Loveable is unable to make the fourteenth loan payment and calls Mr. Generous to make the payment under the loan guarantee. Mr. Loveable is subsequently unable to make any remaining payments under the terms of the loan agreement, and Mr. Generous makes all the remaining payments. When will Mr. Generous be able to write off his guarantee payments as a bad debt loss? **(Page 271)**

    a. After reasonable collection efforts against Mr. Loveable have failed [This answer is correct. In his role as guarantor, under the regulations, Mr. Generous assumes the role of lender and must pursue collection efforts against Mr. Loveable before writing off the debt as uncollectable.]

    b. Monthly as each guarantee payment is made. [This answer is incorrect. It is not determinable at the time each guarantee payment is made if the debt from Mr. Loveable is uncollectable.]

    c. The year the guarantee is written. [This answer is incorrect. Under this scenario, no guarantee payments were made until the guarantee agreement had been in effect for over a year.]

Debt Discharge Income—Solvent Taxpayer

Cancellation or forgiveness of a debt (other than as the result of a gift) results in gross income for the debtor unless an exception applies because he is in bankruptcy or insolvent, or the debt is qualified farm debt, qualified real property business debt, a certain type of student loan, or qualified principal residence indebtedness (see discussions for these exceptions later in this lesson). A special rule applies to a reduction of a seller-financed (i.e., purchase money) debt owed to the seller of the property.

Debt discharge income resulting from debt allocated to passive activity expenditures (e.g., when a rental property's mortgage balance is reduced by a lender) is passive income and can be offset by passive losses. Debt discharge income resulting from the cancellation of investment-related debt is treated as investment income for purposes of the investment interest expense limitation.

Example 2B-1 Loan renegotiation.

Helen borrowed $250,000 for her sole proprietor dress shop in 2006, financing it with a balloon payment loan from Qwik Savings. In 2009, she was forced to sell the business. Unfortunately, its value had dropped to $200,000. Helen found a buyer and then renegotiated the principal balance of her loan from $250,000 to $200,000. She used the $200,000 sale proceeds to pay off the loan. Helen was not insolvent when the loan was renegotiated.

Because Helen was not insolvent when the loan was renegotiated, the full amount of the loan reduction ($50,000) is taxable income from debt discharge in 2009.

Example 2B-2 Discounted payoff of low interest mortgage.

Tom and Sue purchased their vacation home in 2007 by taking out a 4% mortgage. As of July 1, 2009, the mortgage balance was $200,000. The bank offered them a $10,000 discount if they would pay off the mortgage, which Tom and Sue did (for $190,000) on July 15, 2009.

Because Tom and Sue were not insolvent or bankrupt, the $10,000 principal reduction is taxable income from debt discharge in 2009. Because it was a nonbusiness debt, the cancellation of indebtedness income is reported as "Other income" on line 21 of Form 1040.

An exception to the usual treatment of debt discharge income may apply to contested liabilities. If a party demands payment for a liability over which there is a dispute, the eventual agreement to pay a reduced amount may not give rise to debt discharge income. The Third Circuit, in *Zarin*, found that the disputed debt doctrine applied when the debt's existence was in doubt. The taxpayer incurred gambling debts of over $3,000,000 according to a casino. Eventually, he settled with the casino for $500,000. Because the gambling debt was illegal, and thus, unenforceable, the court found the excess of the original debt over the settlement amount was not taxable income. In *Earnshaw*, the taxpayer disputed the amount of interest and late fees added to his credit card balance. When he settled the debt for less than the balance on the credit card company's books, only the amount of the liquidated debt (i.e., the amount fixed by agreement or by the operation of law) over the amount paid was taxable debt discharge income. The cancellation of the disputed charges did not generate debt discharge income.

The Tenth Circuit refused to apply the disputed debt doctrine when the amount but not the existence of the debt was contested.

A loan guarantor who pays off another taxpayer's loan at a discount generally does not recognize debt discharge income because the guarantor is not the primary obligor on the debt. The Tax Court has ruled that a shareholder-guarantor of corporate debt did not recognize debt discharge income upon payment of the debt at a reduced amount. The shareholder was merely the guarantor of the corporate debt; the debt discharge income was attributable to the corporation. Likewise, a taxpayer who transfers property to a lender to release another taxpayer from debt does not realize a gain or loss, since the transferor was not obligated under the debt. Thus, its cancellation is not consideration to the transferor. Without consideration, the court found there could be no gain.

Effect of Debt Modifications

A debtor that issues a new debt instrument in satisfaction of existing debt is treated as having paid off that debt with an amount of money equal to the "issue price" (determined under the OID rules of IRC Secs. 1273–1274) of the new debt. To avoid default, a lender will often modify the terms of a debt in favor of the debtor. Significant modification of the terms of a debt instrument is considered an exchange of old debt for new and may give rise to debt discharge income.

A modification is significant if, based on all facts and circumstances, the legal rights or obligations being changed and the degree to which they are changed are economically significant. To determine this, generally all modifications to the debt instrument are considered collectively (when a series of modifications, if considered separately, would not be significant). However, certain modifications listed in Reg. 1.1001-3(e)(2) though (6) are considered independently. The regulations also provide guidelines for determining whether these independently-considered modifications are significant. The modifications listed in the regulations are:

1. Changes in the obligation's yield.
2. Changes in the timing of payments.
3. Changes in the obligor or security.
4. Changes in the nature of the debt instrument.
5. Changes in customary accounting or financial covenants.

The new (i.e., significantly modified) debt will generate debt discharge income if its issue price is less than the balance of the old debt. Under the OID rules applicable to nonpublicly traded debt, if the new debt has an interest rate at least equal to the applicable federal rate (AFR), and interest is unconditionally payable at least annually, the debt's issue price is deemed to be its stated principal amount. Thus, the issuance of new debt (or significant modification of an existing debt) with a principal balance equal to the old debt will *not* result in debt discharge income, provided the new (or modified) debt's interest rate equals or exceeds the AFR and interest is paid at least annually. However, if the interest rate is less than the AFR or payments occur less frequently than annually, the issue price is generally the present value of all payments required under the terms of the debt discounted at the AFR, and debt discharge income will result.

Example 2B-3 New debt issued for existing debt; interest rate exceeds AFR.

John purchased machinery for his sole proprietorship business on January 1, 2005 financed with a $350,000, 12% note due in 10 years, payable monthly. The balance at January 1, 2009 was $257,000. On January 2, 2009, John and the lender agreed to refinance the note at an 8% annual rate. No other terms were modified.

Because the changed loan terms resulted in a significant modification under Reg. 1.1001-3, the old loan is considered exchanged for a new loan (with a term of six years). However, there are no tax consequences to the refinancing since the stated rate of 8% exceeded the January 2009 midterm AFR. Thus, the issue price of the new debt is deemed to be its stated principal amount ($257,000), which equals the face value of the old debt.

Example 2B-4 New debt issued for existing debt; interest rate less than AFR.

Assume the same facts as in Example 2B-3 except the refinanced rate was 2%. Here, John will be treated as satisfying the old debt with an amount equal to the imputed principal amount of the new debt, which, for this example, assume is $250,000. The difference between the $257,000 stated principal balance and the $250,000 imputed principal amount, or $7,000, is debt discharge income. John reports the $7,000 as income in 2009 unless he is in bankruptcy or insolvent.

Additionally, John is allowed corresponding OID interest deductions of $7,000. The OID deductions are allocated over the remaining term of the note and can be deducted in the applicable tax years.

Acquisition of Debt by Related Party

The direct or indirect acquisition of indebtedness by a person related to the debtor from a person who is not related results in debt discharge income equal to the difference between the outstanding balance of the debt acquired and its FMV. A related person includes family members, more-than-50%-owned corporations, and more-than-50%-owned partnerships, as well as certain trust and beneficiary relationships. For this rule, family members include the debtor's parents, spouse, children, grandchildren, and their spouses.

A direct acquisition occurs if a person related to the debtor acquires the indebtedness from a person who is not. An indirect acquisition is generally a transaction in which the holder of outstanding debt becomes related to the debtor, if the holder is treated as having acquired the debt "in anticipation of" becoming related to the debtor.

Example 2B-5 Acquisition of debt by party related to debtor.

In 2006, Dawn borrowed $500,000 by executing a note with Last Bank. The terms provide for interest payments of 10% due each December 31 and a balloon at maturity of $500,000. The note matures on December 31, 2011. On June 1, 2009, Bloom Corp. (owned 100% by Dawn) purchased the note from Last Bank for $450,000 (its FMV at that time).

Since Bloom is a related party, Dawn recognizes $50,000 of debt discharge income in 2009. The income would be excludable under IRC Sec. 108(a) if Dawn is bankrupt or to the extent she is insolvent.

Special Rules for Farmers

In addition to bankrupt and insolvent taxpayers, farmers do not have to recognize debt discharge income if the forgiven debt is *qualified farm indebtedness*. For this exception, the following conditions must be met:

1. The debt was incurred directly in the business of farming.

2. At least 50% of the taxpayer's gross receipts from all sources, including farming, for the preceding three years were attributable to the business of farming.

3. The lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality.

The amount of debt discharge income excludable by farmers is limited to the total of certain tax attributes plus the aggregate bases of business property and property held for the production of income. To the extent the debt discharge exceeds these attributes, income must be recognized.

Example 2B-6 Discharge of farm indebtedness.

Bill has been in the farming business for 10 years. More than 50% of his annual gross receipts are attributable to farming. In 2006, he borrowed $75,000 from a state agricultural agency for farm operating expenses. For several years, he could not meet certain financial obligations, although he was not insolvent or in bankruptcy. In 2009, the state agency discharged the $70,000 remaining balance of its loan to Bill.

The discharge will not result in income to Bill because he meets the Section 108(g) rules for discharge of qualified farm indebtedness. However, assuming Bill has no other tax attributes that can be reduced, he must reduce his tax basis in depreciable business or income-producing property, then reduce his basis in farmland, and finally reduce his basis in other business or income-producing property to the extent of the $70,000 discharged indebtedness. This basis reduction is reported on Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness). Any debt discharge income in excess of these basis reductions is includable in gross income on the "Other income" line of Schedule F of Bill's Form 1040.

Special Rules for Real Property Business Debt

A taxpayer who is *not* insolvent or bankrupt can elect to exclude from gross income any income from the discharge of qualified real property business debt. Qualified real property business debt includes debt:

1. that was incurred or assumed in connection with real property used in a trade or business and that is secured by such real property;

2. that was incurred or assumed (a) before January 1, 1993, or (b) on or after January 1, 1993 and is qualified acquisition debt (i.e., debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business); and

3. with respect to which an election to invoke the special rules of IRC Sec. 108(a)(1)(D) has been made.

Qualified real property business debt does *not* include qualified farm indebtedness but does include debt incurred to refinance qualified real property business debt (to the extent refinancing proceeds do not exceed the principal amount of the qualified real property business debt being refinanced).

Example 2B-7 Determining qualified real property business debt.

George operates an auto repair shop as a sole proprietor. He purchased a tract of land in 2007 and built his own shop. The cost of the land and building was $200,000, financed by a $25,000 down payment and a $175,000 nonrecourse note obtained from a third-party lender. On July 31, 2009, when the FMV of the land and building is $100,000 and the balance of the note is $150,000, the lender agrees to reduce the principal of the note by $50,000. Since the note is qualified acquisition debt, the debt discharge income is excluded from George's gross income, if he makes the Section 108(a)(1)(D) election.

As previously stated, the debt must be incurred or assumed in connection with a trade or business. This trade or business requirement can be particularly difficult for rental properties to meet and is usually based on the extent of the taxpayer's involvement in the rental activity. In Ltr. Rul. 9426006, the IRS concluded that a taxpayer's involvement was sufficient to constitute a trade or business even though a management company was engaged as the leasing agent and handled day-to-day operations. Rentals conducted as "net leases," however, generally do not qualify as a trade or business.

The taxpayer must make a valid election to exclude income from the discharge of qualified real property business debt. It is made on Form 982 and attached to the taxpayer's return for the tax year the discharge occurs.

Limitation on Exclusion. The amount of qualified real property business debt discharge income that can be excluded cannot exceed the lesser of the following:

1. *FMV Limitation.* The excess of the outstanding principal amount (immediately before the discharge) over the FMV of the real property securing the debt (reduced by the principal amount of any other qualified real property business debt secured by the property). The outstanding principal amount is the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future.

2. *Overall Limitation.* The aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge reduced by depreciation claimed for the year of the excluded debt discharge income.

When applying the overall limitation, the adjusted basis of the taxpayer's depreciable real property must first be reduced by (1) any reduction in basis made under IRC Sec. 108(b) for reductions in tax attributes of a bankrupt or insolvent taxpayer, or (2) any reduction made under IRC Sec. 108(g) for the discharge of qualified farm debt. If depreciable real property is acquired in contemplation of a discharge of qualified real property business debt, the property's basis is not included in applying the overall limitation.

Example 2B-8 Application of real property business debt limitations.

Joan owns a building used in her business. Its FMV is $150,000 (adjusted basis $175,000). The building secures a first mortgage of $110,000 and a second mortgage of $90,000. None of the debt is qualified farm indebtedness. Joan is not insolvent or bankrupt and owns no other depreciable real property.

On July 1, 2009, the second mortgagee agrees to reduce its debt from $90,000 to $30,000, resulting in debt discharge income of $60,000. The FMV rule limits the total amount of debt discharge income that can be excluded to $50,000, the amount by which the principal of the debt ($90,000) exceeds the FMV of the collateral property, reduced by other qualified real property business debt securing the property ($150,000 − $110,000 = $40,000). Therefore, Joan can exclude $50,000 of debt discharge income if she files an election to do so with her 2009 return. The remaining $10,000 of debt discharge income is included in her 2009 income.

Basis Adjustment Requirement. Income excluded for the discharge of qualified real property business debt reduces the basis of the taxpayer's depreciable real property. (The reduction is made under IRC Sec. 1017, except the election to treat real property inventory as depreciable property is not available.) The basis reduction is made first to the adjusted depreciable basis of the real property securing the discharged debt. Any excess reduces the depreciable bases of the taxpayer's other depreciable real property proportionately, based on each property's relative adjusted basis. The basis reduction is deemed to occur at the beginning of the tax year following the tax year during which the discharge occurs. However, if the property is disposed of before the beginning of the tax year following the discharge, the basis reduction occurs immediately before the disposition.

Example 2B-9 Reducing the basis of depreciable real property.

Bill owns Garden Apartments. On July 1, 2009, the property has an adjusted basis of $2.2 million and outstanding nonrecourse debt of $2.5 million. The property's FMV is $2 million.

On July 1, 2009, the mortgage holder reduces the principal amount of the outstanding mortgage to $2 million, resulting in debt discharge income of $500,000. Bill elects to exclude this $500,000 of income under the qualified real property business debt rules. Therefore, his depreciable basis in the apartments is reduced by $500,000 as of January 1, 2011, and depreciation calculated for periods subsequent to that date will take the $500,000 basis reduction into account.

Partnership Debt Reduced. For a discharge of partnership debt, the determination of whether debt is qualified real property business debt and the application of the FMV limitation is made at the partnership level. The election to apply the exclusion is made at the partner level on a partner-by-partner basis. When an election causes a basis reduction to the partner's allocable share of the partnership's depreciable real property, the partner's basis of his interest in the partnership and the partnership's basis of the depreciable realty allocated to the partner are reduced by such amount.

S Corporations Apply Rules at the Entity Level. The income exclusion under IRC Sec. 108 and any resulting reduction in tax attributes are applied at the S corporation level. IRC Sec. 108(d)(7)(A) clarifies that income excluded under IRC Sec. 108 does not increase a shareholder's basis in S corporation stock.

Special Rules for Certain Student Loans

Cancellations of all or part of certain student loans obtained to attend qualified educational institutions do not result in gross income to the borrower. This special rule applies only to student loans that contain a provision stating that all or part of the loan will be cancelled if the borrower works for a certain period of time in certain professions for any of a broad class of employers (i.e., a public service requirement), and the borrower satisfies such requirement. To qualify, the loan must be made by either:

1. a federal, state, or local government unit, or instrumentality, agency, or subdivision thereof;

2. a tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law; or

3. an educational institution that makes the loan under (a) an agreement with an entity described in item 1 or 2, or (b) a program of the institution to encourage students to serve in occupations or in areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or other tax-exempt organization.

Loans made by educational institutions and tax-exempt organizations to refinance loans that assist individuals in attending such educational institution also qualify, provided the refinancing is pursuant to a program as described in item 3 above. Loans from educational institutions and tax-exempt organizations do not qualify if the discharge is on account of services the individual performs for the lender organization.

Special Rules for Principal Residence Debt

Tax payers can exclude from a discharge (in whole or in part) of qualified principal residence indebtedness before January 1, 2013. The exclusion applies where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure. But the exclusion does not apply if the discharge is on account of services performed for the lender (for example, an employee of the lender and the discharge relates to employment services performed) or any other factor not directly related to a decline in the value of the residence or to the taxpayer's financial condition. The exclusion also does not apply to a taxpayer in a Title 11 bankruptcy case; the regular Title 11 bankruptcy exclusion applies. And, insolvent taxpayers other than those in a Title 11 bankruptcy case can elect to not have this special exclusion apply and instead rely on the Section 108(a)(1)(B) rules for insolvent taxpayers.

Qualified Principal Residence Indebtedness. Qualified Principal Residence Indebtedness is debt that meets the Section 163(h)(3)(B) definition of acquisition indebtedness for the residential interest expense rules, but only with respect to the taxpayer's principal residence (i.e., does not include second homes or vacation homes), and with a $2 million limit ($1 million for married filing separate taxpayers) on the aggregate amount of debt that can be treated as qualified principal residence indebtedness.

For purposes of these rules, a principal residence has the same meaning as under the Section 121 home sale gain exclusion rules.

Operative Rules. Most residential mortgages are classified as recourse debt. As such, a foreclosure involving recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven. Therefore, it is possible for a residential foreclosure transaction (involving recourse debt) to result in either a gain or loss from the sale of property and debt discharge income. However, only the portion of the transaction (if any) treated as debt discharge income is available for the special exclusion rule for qualified principal residence indebtedness; any income from the foreclosure treated as gain is not eligible for the exclusion rule.

Example 2B-10 Exclusion for home mortgage debt discharge.

Tim, who is not in bankruptcy and is not insolvent, owns a principal residence that is subject to a $300,000 mortgage secured by the residence. The original cost of the home was $270,000 and the lender foreclosed on the loan in 2009 when the property's FMV was $280,000.

The foreclosure results in a taxable gain of $10,000 ($280,000 less $270,000) and debt discharge income of $20,000 ($300,000 less $280,000). The $10,000 gain must be recognized, but the $20,000 of debt discharge income is excluded.

In a rare case that a residential mortgage is nonrecourse, a foreclosure transfer is treated as a sale or exchange with the full amount of the debt as the amount realized, even if it is greater than the FMV of the property at time of foreclosure. Therefore, there is no debt discharge income and the exclusion rule does not apply.

The basis of the taxpayer's principal residence must be reduced (but not below zero) by the amount of any income excluded under the special principal residence debt exclusion rules.

SELF-STUDY QUIZ

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

27. A solvent debtor must include cancellation or forgiveness of a debt in gross income unless certain exceptions apply. Which of the following is **not** an allowable exception?

    a. The debt is qualified farm debt.

    b. The debt is qualified real property business debt.

    c. The debt is investment-related debt.

    d. The debt is a certain type of student loan.

28. Assuming that a taxpayer is not bankrupt or insolvent, what is the tax consequence to the taxpayer when a person related to the taxpayer either directly or indirectly acquires the taxpayer's debt from a person who is not related to the taxpayer?

    a. The taxpayer must recognize debt discharge income equal to the difference between the outstanding balance of the debt acquired and its fair market value.

    b. The debt discharge income is excluded from the taxpayer's gross income, but certain tax attributes must be reduced by the amount of the excluded debt discharge income.

    c. The taxpayer must recognize debt discharge income equal to the outstanding balance of the debt acquired.

    d. The taxpayer must recognize debt discharge income equal to the fair market value of the debt acquired.

29. Taxpayers in the business of farming are not required to recognize debt discharge income if the forgiven debt qualifies as *qualified farm indebtedness*. Of the following, which one is **not** a condition that must be met to qualify as qualified farm indebtedness?

    a. The forgiveness is made by a lender who is actively and regularly engaged in the business of lending money, and is not related to the taxpayer.

    b. The debt must have been incurred directly in connection with the trade or business of farming.

    c. 50% or more of the taxpayer's aggregate gross receipts for the preceding three years were from the farming business.

    d. The debt must have been incurred or assumed before 1993.

30. The fair market value limitation and the overall limitation apply in determining the amount of debt discharge income that may be excluded from what type of debt?

    a. Qualified farm indebtedness.

    b. Qualified real property business debt.

    c. Qualified principal residence indebtedness.

    d. Qualified personal indebtedness.

31. In 2009, Dan and Carol's principal residence is subject to a $500,000 mortgage that is secured by the property. Dan and Carol are not bankrupt or insolvent. As a result of nonpayment on the mortgage, the creditors foreclosed on the property when the fair market value of the property was $480,000. Dan and Carol's tax basis in the property is $450,000. How do Dan and Carol report the foreclosure on their tax return?

    a. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is excluded from income.

    b. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is included in income.

    c. The foreclosure results in discharge of indebtedness income of $50,000 that is excluded from income.

    d. The foreclosure results in discharge of indebtedness income of $50,000 that is included in income.

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.)**

27. A solvent debtor must include cancellation or forgiveness of a debt in gross income unless certain exceptions apply. Which of the following is **not** an allowable exception? **(Page 281)**

    a. The debt is qualified farm debt. [This answer is incorrect. Farmers do not have to recognize debt discharge income for the forgiveness of qualified debt.]

    b. The debt is qualified real property business debt. [This answer is incorrect. Cancellation of qualified real property business debt may be excluded from gross income.]

    c. The debt is investment-related debt. [This answer is correct. According to an IRS letter ruling, debt discharge income resulting from the cancellation of investment-related debt is treated as investment income for purposes of the investment interest expense limitation.]

    d. The debt is a certain type of student loan. [This answer is incorrect. The cancellation of certain student loans obtained to attend qualified educational institutions do not result in gross income to the borrower.]

28. Assuming that a taxpayer is not bankrupt or insolvent, what is the tax consequence to the taxpayer when a person related to the taxpayer either directly or indirectly acquires the taxpayer's debt from a person who is not related to the taxpayer? **(Page 281)**

    a. The taxpayer must recognize debt discharge income equal to the difference between the outstanding balance of the debt acquired and its fair market value. [This answer is correct. Under the Internal Revenue Code, these are the appropriate tax consequences in this situation. A related person includes family members, more-than-50%-owned corporations, and more-than-50%-owned partnerships, as well as certain trust and beneficiary relationships.]

    b. The debt discharge income is excluded from the taxpayer's gross income, but certain tax attributes must be reduced by the amount of the excluded debt discharge income. [This answer is incorrect. If the taxpayer is bankrupt or insolvent, the debt discharge income is excluded from gross income.]

    c. The taxpayer must recognize debt discharge income equal to the outstanding balance of the debt acquired. [This answer is incorrect. The calculation of the amount of income that must be recognized is is not correctly stated by this answer choice.]

    d. The taxpayer must recognize debt discharge income equal to the fair market value of the debt acquired. [This answer is incorrect. The amount of income that must be recognized is a calculation that includes the fair market value of the debt acquired. There is a better answer choice.]

29. Taxpayers in the business of farming are not required to recognize debt discharge income if the forgiven debt qualifies as *qualified farm indebtedness*. Of the following, which one is **not** a condition that must be met to qualify as qualified farm indebtedness? **(Page 281)**

    a. The forgiveness is made by a lender who is actively and regularly engaged in the business of lending money, and is not related to the taxpayer. [This answer is incorrect. This condition must be met for the debt to qualify as qualified farm indebtedness.]

    b. The debt must have been incurred directly in connection with the trade or business of farming. [This answer is incorrect. This condition must be met for the debt to qualify, under the code as qualified farm indebtedness.]

    c. 50% or more of the taxpayer's aggregate gross receipts for the preceding three years were from the farming business. [This answer is incorrect. To qualify as qualified farm indebtedness, this condition must be met.]

    d. The debt must have been incurred or assumed before 1993. [This answer is correct. This condition relates to the Internal Revenue's Code's conditions for qualified real property debt instead of qualified farm indebtedness.]

30. The fair market value limitation and the overall limitation apply in determining the amount of debt discharge income that may be excluded from what type of debt? **(Page 281)**

    a. Qualified farm indebtedness. [This answer is incorrect. Although qualified farm indebtedness is subject to certain conditions, the FMV and overall limitations apply to another type of debt.]

    b. Qualified real property business debt. [This answer is correct. According to the Internal Revenue Code, the amount of qualified real property business debt discharge income that can be excluded cannot exceed the lesser of the fair market value limitation or the overall limitation.]

    c. Qualified principal residence indebtedness. [This answer is incorrect. Although qualified principal residence indebtedness is subject to exclusion rules, the FMV and overall limitations apply to another type of debt.]

    d. Qualified personal indebtedness. [This answer is incorrect. Although bankrupt and insolvent taxpayers can exclude debt discharge income from taxable gross income, they must reduce certain tax attributes. The FMV and overall limitations apply to another type of debt.]

31. In 2009, Dan and Carol's principal residence is subject to a $500,000 mortgage that is secured by the property. Dan and Carol are not bankrupt or insolvent. As a result of nonpayment on the mortgage, the creditors foreclosed on the property when the fair market value of the property was $480,000. Dan and Carol's tax basis in the property is $450,000. How do Dan and Carol report the foreclosure on their tax return? **(Page 281)**

    a. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is excluded from income. [This answer is correct. Under the Code, this is the proper treatment. The excess of the FMV of the property over the tax basis is taxable gain from the sale of the property ($480,000 — $450,000). The excess of the debt forgiven over the FMV is debt discharge income ($500,000 — $480,000).]

    b. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is included in income. [This answer is incorrect. Including debt discharge income as income is not the proper tax treatment of the transaction.]

    c. The foreclosure results in discharge of indebtedness income of $50,000 that is excluded from income. [This answer is incorrect. A foreclosure involving recourse debt is treated as a deemed sale of the property which results in a taxable gain or loss.]

    d. The foreclosure results in discharge of indebtedness income of $50,000 that is included in income. [This answer is incorrect A foreclosure involving recourse debt is treated as a deemed sale of the property which results in a taxable gain or loss. In addition, including debt discharge income as income is not the proper tax treatment for the transaction.]

Bankrupt or Insolvent Taxpayer—Debt Discharge Income

Special mandatory relief provisions apply to debt discharge income of bankrupt or insolvent taxpayers. These relief provisions allow such taxpayers to exclude debt discharge income from gross income. However, certain tax attributes are reduced by the amount of excluded debt discharge income. To the extent the excluded income exceeds the tax attributes available for reduction, the "excess" income, in effect, disappears (with no further tax consequences to the debtor). (See Example 2C-6.)

Amount Excludable from Gross Income

Bankrupt Taxpayers. *Bankrupt* taxpayers exclude all debt discharge income from taxable gross income under these rules. *Bankrupt* means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 (of the U.S. Bankruptcy Code) case. Title 11 encompasses the federal bankruptcy statutes and includes Chapter 7 (liquidation), Chapter 11 (business reorganization), Chapter 12 (family farmer or fisherman), and Chapter 13 (adjustment of an individual's debts) bankruptcies.

Example 2C-1 Excludable debt discharge income for taxpayer in bankruptcy.

Horton's sole proprietorship business failed in 2009. He also owns land (free and clear) worth $300,000 that he holds for investment. In November 2009, the bankruptcy judge granted Horton a discharge from $400,000 of personal indebtedness related to his failed business (in a Chapter 7 case). He had no assets other than the land and no other liabilities at the time of this debt discharge.

Horton can exclude the entire $400,000 from taxable gross income under IRC Sec. 108 because the debt discharge occurred in a Title 11 bankruptcy proceeding. (See Examples 2C-5, 2C-6, and 2C-7 for discussions of the tax attribute reduction rules.)

Insolvent Taxpayers. *Insolvent* taxpayers exclude debt discharge income from taxable gross income to the extent of insolvency before the debt discharge transaction. Any debt discharge income in excess of insolvency is taxable income. The extent of insolvency is the excess of the taxpayer's liabilities over the FMV of his assets immediately before the debt discharge.

When determining whether a taxpayer is insolvent or the extent of insolvency, the following rules apply:

- *Exempt Assets.* All assets, including assets that, by operation of state law, are exempt from creditors must be included in determining insolvency.
- *Spouse's Separate Property.* A spouse's separately-owned assets can be excluded from the determination of the insolvent spouse's net worth, even if the couple files a joint return.
- *Nonrecourse Debt.* When computing insolvency, nonrecourse debt is treated as a liability to the extent of the FMV of the property securing the debt. Nonrecourse debt in excess of the property's FMV is treated as a liability to the extent it is discharged; otherwise, it is ignored.
- *Contingent Liabilities.* Before a contingent liability can be included in the insolvency computation, taxpayers must be able to prove "it is more probable than not" that they will be called on to pay the liability. Thus, loan guarantees and disputed debts may or may not be considered, depending on the facts and circumstances.
- *Measurement Date.* IRC Sec. 108(d)(3) indicates a taxpayer's insolvency is determined immediately before a debt discharge. According to the Tax Court, this means the day before the debt forgiveness income is realized.

Example 2C-2 Excludable debt discharge income for insolvent taxpayer.

All of Max's personal assets and liabilities are from his sole proprietorship business. As of August 1, 2009, business operating debts owed to Last Bank were $500,000, and the FMV of business assets was only $350,000.

The bank discharges $200,000 of Max's debts in exchange for his promise to take no money out of the business until it becomes healthy. This debt discharge occurs outside of bankruptcy in a voluntary "workout" between the borrower and lender.

Just before the debt discharge, Max was insolvent to the extent of $150,000 ($500,000 of liabilities less $350,000 FMV of assets). Thus, he can exclude $150,000 of the $200,000 discharge from income. However, he must reduce tax attributes by up to $150,000. (See Examples 2C-6 and 2C-7.)

The remaining $50,000 of debt discharge income must be included in Max's income. After the debt discharge, his assets are still worth $350,000, and his liabilities are only $300,000. Thus, $50,000 is taxable because he has been made solvent by that amount as a result of the debt discharge transaction.

Example 2C-3 Effect of nonrecourse debt on insolvency calculations.

In 2007, Sally borrowed $200,000 from Bob to purchase land valued at $200,000. The note bore interest at a fixed market rate payable annually; no principal payments were due until 2009. The note was secured by the land and was nonrecourse to Sally.

In 2009 (when the outstanding note balance was still $200,000 and the FMV of the property had declined to $100,000), Bob agreed to reduce the note's principal balance to $150,000. At that time, Sally had other assets valued at $100,000 and other liabilities (for which she was personally liable) of $90,000. She had not declared bankruptcy. What are the tax consequences of this transaction?

Sally was discharged from $50,000 of debt in 2009. However, she will not recognize debt discharge income to the extent she was insolvent immediately before the discharge. The FMV of Sally's assets before the debt discharge was $200,000 ($100,000 land plus $100,000 other assets). In calculating Sally's insolvency, her liabilities were $240,000 ($100,000 nonrecourse financing, included to the extent of the FMV of the secured property, plus $50,000 nonrecourse financing in excess of the secured property's FMV, included to the extent discharged, plus $90,000 other recourse debt). Thus, Sally is insolvent to the extent of $40,000 ($200,000 assets − $240,000 liabilities) immediately before the discharge. She will recognize $10,000 ($50,000 debt discharged − $40,000 excluded under the insolvency rule) of debt discharge income in 2009. (See Examples 2C-6 and 2C-7 for tax attribute reduction rules that apply.)

When an insolvent taxpayer's debt is partly discharged and partly satisfied by the transfer of property, the transaction must be bifurcated between the debt discharge and the property disposition (*Gehl*). The amount of debt satisfied by the transfer of the property is treated as sales proceeds for the property, from which gain or loss is computed. The separate debt discharge amount is eligible for exclusion under IRC Sec. 108, to the extent the taxpayer is insolvent.

Example 2C-4 Property transferred by insolvent debtor.

Tad transfers a vacant lot with an FMV of $30,000 and $5,000 cash in complete settlement of a $50,000 unsecured loan from the bank. The bank forgives the remaining $15,000 of the loan. Assume Tad is insolvent both before and after the debt discharge. His basis in the lot was $25,000. The transfer of the property and the debt discharge are treated as two separate transactions. The transfer of the lot is considered a sale of the property, so Tad has a $5,000 taxable gain based on the difference between the FMV and basis ($30,000 − $25,000). The $15,000 debt discharge amount is excluded from Tad's income under the insolvency rule.

Reduction of Tax Attributes

While bankrupt and insolvent taxpayers can exclude debt discharge income from taxable gross income, they must reduce (to the extent possible) certain tax attributes. This reduction of attributes means that some or all of the excluded debt discharge income will eventually be recognized because of reduced tax attributes or basis in property.

The following tax attributes are reduced by debt discharge income (dollar for dollar, except for credits, which are reduced by 33 1/3 cents for each dollar) in the following order:

1. *NOLs.* Any NOL from the tax year of debt discharge, and any NOL carried into that year.

2. *General Business Credits.* Any credit carryover to or from the year of discharge.

3. *Minimum Tax Credit.* Any credit under IRC Sec. 53(b) as of the beginning of the year following the year of discharge.

4. *Capital Loss Carryovers.* Any net capital loss from the year of discharge, and any capital loss carryover into that year.

5. *Basis.* The tax basis of the depreciable and nondepreciable property of the taxpayer—under the rules prescribed in IRC Sec. 1017. (See "Ordering Rules for Basis Reduction" discussed later in this lesson.)

6. *Passive Activity Loss and Credit Carryovers.* Any passive activity loss or credit carryover under IRC Sec. 469(b) from the year of discharge.

7. *Foreign Tax Credit Carryovers.* Any credit carryover to or from the year of discharge.

When determining the amount of debt discharged under bankruptcy law, taxpayers need to consider that as a debtor, "all debts that arose before the date of the bankruptcy order are discharged even if the creditor did not file proof of claim on the debts. If the debt existed, such as mortgage liens, prior to the bankruptcy, and they are part of the bankruptcy estate, they can reduce the taxpayers subsequent tax attributes such as the net operating loss deduction.

Basis Reduction Elections

Two basis reduction elections are available to bankrupt and insolvent taxpayers. Instead of reducing tax attributes in the order just described, the taxpayer can elect under IRC Sec. 108(b)(5) to first reduce the basis of *depreciable* assets. Excluded debt discharge income in excess of the basis of depreciable assets is then used to reduce other attributes according to the normal ordering procedure. This "basis reduction" election can be beneficial to taxpayers with NOL or credit carryovers (that will be used in the near future) and long-lived depreciable property. Bankrupt or insolvent taxpayers who make the Section 108(b)(5) election can also elect under IRC Sec. 1017 to treat real property inventory as depreciable property.

Ordering Rules for Basis Reduction

For debt discharges that result in a reduction in the taxpayer's basis in assets due to the exclusion of debt discharge income, basis in assets is reduced in the following order:

1. Real property used in a trade or business (other than inventory) or held for investment that secured the debt.

2. Personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that secured the debt.

3. Any excess of the amount excluded from gross income over the adjustments in items 1 and 2 reduces the basis of the remaining trade or business property (other than inventory, accounts receivable, or notes receivable) and property held for investment.

4. Any excess of the amount excluded from gross income over the adjustments in items 1–3 reduces the adjusted basis of inventory (including real property held as inventory), accounts receivable, and notes receivable.

5. Any excess of the amount excluded from gross income over the adjustments in items 1–4 reduces the adjusted basis of any remaining property.

Generally, reduction resulting from adjustments in items 3–5 is allocated within each category of assets as follows:

$$\frac{\text{Adjusted basis of the property}}{\text{Adjusted basis of all property in that category}} \times \text{Excess debt discharge income}$$

Example 2C-5 Impact of basis reduction on Section 1250 property.

Rigby purchased an office-warehouse on June 5, 2005 for use as a rental property. All $500,000 of his purchase price was allocated to building. During 2009, Rigby declared Chapter 13 bankruptcy and was relieved of significant liabilities. Pursuant to IRC Sec. 1017, he reduced the basis in the office-warehouse by $80,000. At the end of 2009 (before considering the Section 1017 basis adjustment), Rigby's adjusted basis in the building was $441,772 ($500,000 cost less $58,228 straight-line depreciation). Rigby sells the building for $450,000 on January 1, 2010. The Section 1017 basis reduction occurs on the first day of 2010—see "Timing of Attribute Reduction" later in this lesson resulting in an adjusted basis of $361,772 ($441,772 − $80,000).

Rigby realizes a gain of $88,228 ($450,000 − $361,772). Straight line depreciation that would have been allowed (for computing recapture) is $58,228. Depreciation taken (including the Section 1017 basis adjustment) is $138,228. The difference between those amounts, $80,000, is recaptured as ordinary income. The remaining gain of $8,228 ($88,228 − $80,000) is Section 1231 gain.

Variation: Assume instead that Rigby sells the building nine years later for $450,000 (on January 1, 2019), realizing a $185,149 gain. His adjusted basis at that time would be $264,851 ($361,772 adjusted basis on January 1, 2010 less $96,921 additional straight line depreciation taken over nine years on $420,000 depreciable basis). Thus, total depreciation taken at the time of the sale (including the Section 1017 basis reduction) is $235,149 ($138,228 + $96,921). Total straight line depreciation that would have been allowed is $173,617 (based on the original $500,000 basis). Thus, $61,532 ($235,149 − $173,617) of the gain is recaptured as ordinary income, and the remaining gain of $123,617 ($185,149 − $61,532) is Section 1231 gain, which is taxed as Unrecaptured Section 1250 gain (25%), unless the taxpayer has any nonrecaptured Section 1231 losses.

Basis Reduction Limitation. If the basis of a taxpayer's property is reduced under the general attribute reduction ordering rules (i.e., after NOL, general business credit, minimum tax credit, and capital loss carryovers, if any, have been reduced), a special limitation on the amount of basis reduction applies. The aggregate basis of the taxpayer's assets cannot be reduced below the aggregate of the taxpayer's liabilities immediately after the discharge. This limitation does not apply to depreciable property if the election is made to first reduce its basis before other tax attributes. However, the basis of depreciable property cannot be reduced below zero. (Compare Examples 2C-6 and 2C-7.)

Timing of Attribute Reduction

When tax attributes of bankrupt or insolvent taxpayers are reduced because of excluded debt discharge income, the required attribute reductions are deemed to occur *after* taxable income for the year of discharge has been determined. This rule allows the taxpayer to use any NOL, capital loss, or credit carryovers into the year of discharge to offset other taxable income for that year before the carryovers are reduced for debt discharge income. Furthermore, the taxpayer can depreciate or amortize the full tax basis of property in computing taxable income for the year of discharge before reducing tax basis because of excludable debt discharge income. In effect, the attribute reductions occur on the first day of the tax year after the debt discharge occurs.

Example 2C-6 Attribute reduction for insolvent taxpayer.

Roxanne runs a toy distribution business as a sole proprietorship. National Bank continued to lend money to her even though she had financial problems. Roxanne stopped paying interest to the bank for most of 2009. As a result, she made a profit. At the end of 2009, the bank agreed (outside of bankruptcy proceedings) to forgive $150,000 of Roxanne's debts. Before the debt forgiveness, her liabilities were $500,000, and the FMV of her assets was $490,000. After the discharge, she had $350,000 of liabilities.

Roxanne had the following 2009 tax information:

NOL carryover into 2009	$ 60,000
Capital loss carryover into 2009	5,000
Credit carryover into 2009	1,000
Tax basis of depreciable assets at December 31, 2009	120,000
Tax basis of inventory at December 31, 2009	124,000
Tax basis of other property at December 31, 2009	100,000
2008 taxable income before any debt discharge income	25,000

The $150,000 debt discharge is treated as follows:

Roxanne can exclude only $10,000 from gross income—the amount by which her predischarge liabilities ($500,000) exceeded the FMV of her assets ($490,000). The $10,000 of excludable debt discharge income means tax attributes must be reduced by that amount, to the extent possible. The remaining $140,000 of debt discharge income is included in Roxanne's 2009 income.

Roxanne's tax attributes are reduced only after her 2009 taxable income has been computed. Thus, her NOL carryover of $60,000 into 2009 is used to offset 2009 taxable income of $165,000 ($25,000 + $140,000 of nonexcludable debt discharge income). Of her $5,000 capital loss carryover into 2009, $3,000 (the annual maximum) is used, leaving only $2,000. Finally, Roxanne can use all of her $1,000 credit carryover to reduce her 2009 tax liability. Thus, the only carryover remaining for attribute reduction after the determination of Roxanne's 2009 taxable income is the $2,000 capital loss carryover. That carryover is eliminated under the attribute reduction rules. Because her aggregate liabilities after the discharge ($350,000) exceed the aggregate tax basis of her property ($344,000), no basis reduction is required. Therefore, no further attribute reduction occurs.

In summary, Roxanne can exclude $10,000 of debt discharge from taxable gross income, and her tax attributes are reduced by only $2,000. The remaining $8,000 of excluded debt discharge income vanishes without impacting Roxanne's tax situation.

Example 2C-7 Election to reduce basis of depreciable assets.

Assume the same facts as in Example 2C-6 except Roxanne elects to first reduce the tax basis of depreciable property before reducing other tax attributes. Generally, the overall basis reduction cannot exceed the excess of the aggregate of the bases of property over liabilities immediately after the discharge. However, this limitation does not apply to depreciable property if the election to first reduce basis before other tax attributes is made. Roxanne's tax basis in her depreciable property on January 1, 2010 would be reduced from $120,000 to $110,000. This would not affect her 2009 depreciation calculation; however, only $110,000 of depreciable basis would be available going into 2010.

The difference in the tax impact on Roxanne as compared to the result in Example 2C-6 is that all $10,000 of excluded debt discharge income causes a reduction in tax attributes. In this set of facts, Roxanne should *not* make the election to first reduce the basis of depreciable property before reducing other tax attributes.

SELF-STUDY QUIZ

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

32. For purposes of the tax rules involving debt discharge, *bankrupt* means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 case. Title 11 encompasses several types of bankruptcies, including Chapter 13 bankruptcies. Which of the following falls under Chapter 13 bankruptcies?

    a. Liquidation.

    b. Business reorganization.

    c. Adjustment of debts of a family farmer or fisherman.

    d. Adjustment of debts of an individual.

33. When the taxpayer is insolvent, the amount of debt discharge income that can be excluded from taxable income cannot exceed the amount by which the taxpayer is insolvent. In this case, *insolvency* means which of the following with respect to the taxpayer?

    a. The total balance of the taxpayer's liabilities immediately before the discharge.

    b. The excess of liabilities over the FMV of assets 180 days before the debt discharge.

    c. The excess of liabilities over the FMV of assets immediately before the debt discharge.

    d. The outstanding balance of the debt that is delinquent.

34. Bankrupt and insolvent taxpayers must reduce certain tax attributes by the amount of debt discharge income that is excluded from taxable income. The following tax attributes are reduced by debt discharge income on a dollar-for-dollar basis **except** for which one?

    a. Net operating loss carryovers.

    b. General business credits.

    c. Capital loss carryovers.

    d. Basis.

35. Jack owns an office supply company. Due to increased competition and rising costs, Jack is unable to repay all of his debt to the local bank. Since Jack has been an active community leader for a long time, the bank forgives $50,000 of his debt on the last day of the current year. Jack's liabilities were $150,000 before the discharge of the debt and $100,000 after discharge of debt. The FMV of Jack's assets before the debt discharge is $130,000. Jack has a net operating loss carryover to the current year of $60,000. At the end of the current year, the tax bases of his assets consist of $80,000 depreciable assets and $10,000 of inventory. In addition, Jack has taxable income of $25,000 before the debt discharge. Assuming that Jack does not elect to first reduce the basis of depreciable property, what is the amount of reduction to his tax attributes for the excluded debt discharge income?

    a. $50,000.

    b. $20,000.

    c. $15,000.

    d. $5,000.

36. Assuming the same facts for Jack in the above question except that Jack elects to first reduce the basis of depreciable property before reducing other tax attributes, what is the amount of reduction to his tax attributes for the excluded debt discharge income?

    a. $50,000.

    b. $20,000.

    c. $15,000.

    d. $5,000.

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.)**

32. For purposes of the tax rules involving debt discharge, *bankrupt* means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 case. Title 11 encompasses several types of bankruptcies, including Chapter 13 bankruptcies. Which of the following falls under Chapter 13 bankruptcies? **(Page 291)**

    a. Liquidation. [This answer is incorrect. Chapter 7 bankruptcies apply to liquidations.]

    b. Business reorganization. [This answer is incorrect. Chapter 11 applies to reorganizations.]

    c. Adjustment of debts of a family farmer or fisherman. [This answer is incorrect. Chapter 12 applies to this group filing for bankruptcy.]

    d. Adjustment of debts of an individual. [This answer is correct. Under the U.S. Bankruptcy Code, Chapter 13 applies to an individual's debts.)

33. When the taxpayer is insolvent, the amount of debt discharge income that can be excluded from taxable income cannot exceed the amount by which the taxpayer is insolvent. In this case, *insolvency* means which of the following with respect to the taxpayer? **(Page 291)**

    a. The total balance of the taxpayer's liabilities immediately before the discharge. [This answer is incorrect. Determining insolvency involves more than referring to the liabilities balance; a calculation is required.]

    b. The excess of liabilities over the FMV of assets 180 days before the debt discharge. [This answer is incorrect. The taxpayer's financial status immediately before the debt discharge is used in determining the insolvency amount.]

    c. The excess of liabilities over the FMV of assets immediately before the debt discharge. [This answer is correct. This statement describes insolvency under the Code. For example, a taxpayer's debt to a lender is $10,000. The lender discharges the debt at which time the taxpayer's assets have a FMV of $6,000. The amount of insolvency is $4,000 ($10,000 – $6,000).

    d. The outstanding balance of the debt that is delinquent. [This answer is incorrect. The balances of all liabilities must be compared to total assets.]

34. Bankrupt and insolvent taxpayers must reduce certain tax attributes by the amount of debt discharge income that is excluded from taxable income. The following tax attributes are reduced by debt discharge income on a dollar-for-dollar basis **except** for which one? **(Page 291)**

    a. Net operating loss carryovers. [This answer is incorrect. According to the Internal Revenue Code, this tax attribute is reduced on a dollar-for-dollar basis by the amount of the debt discharge excluded from taxable income.]

    b. General business credits. [This answer is correct. Under the Code, credit carryovers are reduced by 33 ⅓ cents for each dollar.]

    c. Capital loss carryovers. [This answer is incorrect. Based on the Code, this tax attribute is reduced on a dollar-for-dollar basis by the amount of the debt discharge excluded from taxable income.]

    d. Basis. [This answer is incorrect. This tax attribute is reduced on a dollar-for-dollar basis by the amount of the debt discharge excluded from taxable income under the Code.]

35. Jack owns an office supply company. Due to increased competition and rising costs, Jack is unable to repay all of his debt to the local bank. Since Jack has been an active community leader for a long time, the bank forgives $50,000 of his debt on the last day of the current year. Jack's liabilities were $150,000 before the discharge of the debt and $100,000 after discharge of debt. The FMV of Jack's assets before the debt discharge is $130,000. Jack has a net operating loss carryover to the current year of $60,000. At the end of the current year, the tax bases of his assets consist of $80,000 depreciable assets and $10,000 of inventory. In addition, Jack has taxable income of $25,000 before the debt discharge. Assuming that Jack does not elect to first reduce the basis of depreciable property, what is the amount of reduction to his tax attributes for the excluded debt discharge income? **(Page 291)**

    a. $50,000. [This answer is incorrect. This is the amount is the gross discharge amount of which $20,000 is excludable and $30,000 is taxable.]

    b. $20,000. [This answer is incorrect. Jack's insolvency is the excess of his liabilities over the FMV of his assets immediately before the discharge, or $20,000 (150,000 − 130,000). The remaining amount of the discharge of $30,000 ($50,000 − $20,000) must be included in taxable income.]

    c. $15,000. [This answer is incorrect. This is the amount of debt discharge that is excluded from income but did not require a reduction to Jack's tax attributes after the reduction to the NOL carryover ($20,000 − $5,000).]

    d. $5,000. [This answer is correct. Since the tax bases of the assets of $90,000 ($80,000 + $10,000) exceed the liabilities of $100,000 ($150,000 − $50,000) immediately after the discharge, the only tax attribute that must be reduced is the NOL carryover. The NOL carryover of $60,000 remaining after the current year taxable income of $55,000 ($25,000 + $30,000) is $5,000. Thus, the NOL carryover is eliminated by the attribute reduction of $5,000.]

36. Assuming the same facts for Jack in the above question except that Jack elects to first reduce the basis of depreciable property before reducing other tax attributes, what is the amount of reduction to his tax attributes for the excluded debt discharge income? **(Page 291)**

    a. $50,000. [This answer is incorrect. This is the amount is the gross discharge amount of which $20,000 is excludable and $30,000 is taxable.]

    b. $20,000. [This answer is correct. Since Jack made the election to first reduce the basis of depreciable property, the amount excluded from income reduces the basis of his depreciable property to $60,000 ($80,000 − $20,000).]

    c. $15,000. [This answer is incorrect. This is the amount of debt discharge excluded from income that would not have required a reduction to tax attributes if Jack had not made the election to first reduce the basis of depreciable assets.]

    d. $5,000. [This answer is incorrect. This is the amount of debt discharge excluded from income that would have been a reduction to the tax attributes if Jack had not made the election to first reduce the basis of depreciable assets.]

Recourse Debt—Foreclosure by Lender

A foreclosure (or deed in lieu of foreclosure) transaction may result in debt discharge income to the borrower when recourse debt is involved. The taking of the property by the lender in satisfaction of the recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven.

As a result of these rules, it is possible for a foreclosure transaction involving recourse debt to result in both (1) a gain or loss from the sale of the property (because FMV is more or less than basis) and (2) debt discharge income (because the secured debt is in excess of FMV). The amount credited or received in the foreclosure sale determines sales proceeds for computing gain or loss. The character of the gain or loss depends on the character of the property subject to foreclosure.

Debt discharge income occurs in a foreclosure transaction only if the lender discharges part or all of any deficiency (excess of indebtedness over the property's FMV) upon taking the property securing it. If the lender continues to pursue the debtor for the deficiency, debt discharge income does not result until that deficiency is discharged for less than full value. If the lender fails to pursue the debtor or to discharge all the indebtedness, debt discharge income results when the statute (under state law) for enforcing the debt expires.

Nonrecourse Debt—Foreclosure by Lender

A foreclosure (or deed in lieu of foreclosure) transaction involving nonrecourse debt is treated as a deemed sale by the borrower to the lender with proceeds equal to the amount of nonrecourse debt. An abandonment of real property encumbered by nonrecourse financing is also treated as a deemed sale.

The amount realized on the deemed sale includes the full amount of the nonrecourse debt plus any additions to principal for items (such as accrued interest) that previously generated ordinary deductions for the borrower. For a cash-basis borrower, however, the amount realized on the deemed sale equals only the principal balance of the nonrecourse debt.

Treating the full amount of nonrecourse debt principal as the amount realized from a deemed sale means there can be no debt discharge income due to a foreclosure or deed in lieu transaction involving only nonrecourse debt. Unlike the treatment of foreclosures involving recourse debt, the FMV of the property is irrelevant. Also, insolvent or bankrupt status of the taxpayer does not affect the results.

Example 2E-1 Deeding back land in satisfaction of nonrecourse debt.

Frank purchased a parcel of land on July 1, 2006, for $320,000. He paid $32,000 down, with the balance due to the seller under a nonrecourse "contract for deed" arrangement. Annual payments of $10,000 of principal, plus interest, are due each July 1.

Frank made the payments on July 1, 2007, and July 1, 2008. However, he determined in July 2009 that it was not beneficial for him to continue to make payments on the land; his outstanding debt on the land was $268,000, and its value was only $200,000. Frank agreed to transfer the land back to the seller in full satisfaction of the debt on December 1, 2009. Because this is a satisfaction of *nonrecourse* indebtedness, the outstanding debt amount ($268,000) becomes the deemed sales price of the land. Since the adjusted basis is $320,000, this transaction results in a capital loss of $52,000 for Frank. There is no debt discharge income because the debt was all nonrecourse.

Example 2E-2 Deeding back depreciable real estate in satisfaction of nonrecourse debt.

Lotta purchased an apartment building in 2000. She financed the entire purchase with a $500,000 nonrecourse loan from Bucks Savings. By the end of 2009, the land and building had an adjusted tax basis of $350,000, and the building was experiencing negative cash flow.

Lotta could not continue to fund the negative cash flow, and on December 31, 2009 she deeded the building back to Bucks. At the time of the transfer, the nonrecourse loan principal balance was $497,000. Lotta was insolvent as of December 31, 2009.

The transfer to the lender is a deemed sale for $497,000—the amount of nonrecourse debt satisfied by the transfer. Thus, Lotta has a 2009 gain of $147,000 ($497,000 sales proceeds − $350,000 adjusted basis). None of the gain can be characterized as excludable debt discharge income, even though Lotta was insolvent when the property was deeded back.

Reduction of Seller-financed Debt

A special rule may apply when seller-financed (i.e., purchase money) debt of the property purchaser is reduced. This rule applies only if (1) the creditor is the original seller of the property, (2) the debt arose from the debtor's purchase of the property, and (3) the purchaser (debtor) would recognize debt discharge income except for this provision (i.e., the purchaser is not bankrupt or insolvent and did not make a qualified real property debt election).

If these conditions are satisfied, the purchaser reduces the basis in the property acquired with the seller-financed debt and does not recognize debt discharge income. This treatment is not elective; it is mandatory if the requirements of IRC Sec. 108(e)(5) are met.

Example 2F-1 Reduction of seller-financed residential mortgage.

Stella bought her residence from Fran in 2006 for $135,000. Fran financed the transaction by taking back a recourse $125,000 mortgage from Stella in addition to receiving a $10,000 cash down payment. Stella made her payments to Fran until the middle of 2009. She threatened to abandon the property unless Fran reduced the remaining mortgage debt. (The property had substantially decreased in value.)

Fran agreed to reduce the remaining balance of Stella's mortgage from $121,000 to $100,000, and Stella agreed to make payments to Fran under a revised loan amortization schedule. Stella was solvent at the time of the debt reduction.

Stella must reduce her basis in the home by $21,000 to reflect the reduction in the purchase money debt owed to Fran. Stella does not recognize any debt discharge income because (1) the debt arose from the purchase of the property, (2) the original seller of the property held the obligation that was reduced, and (3) Stella was solvent at the time.

Variation: The result would be the same even if the purchase money debt involved was nonrecourse instead of recourse. If the requirements of IRC Sec. 108(e)(5) are met, basis reduction is mandatory; whether the debt is recourse or nonrecourse is irrelevant.

The seller-financed debt basis reduction rule applies to a partially insolvent taxpayer to the extent he is solvent. Therefore, a taxpayer can exclude debt discharge income (1) to the extent he is insolvent under the general rules of IRC Sec. 108(a), and (2) in excess of his insolvency under the seller-financed debt rule discussed in this lesson—assuming the rule otherwise applies.

The reduction of undersecured nonrecourse debt by a third-party lender (i.e., a lender other than the seller) is treated as a Section 108(e)(5) purchase price reduction (i.e., resulting in a reduction of basis rather than debt discharge income) to the extent the reduction is based on an infirmity that clearly relates to the original sale (e.g., the seller's inducement of a higher purchase price by misrepresentation of a material fact or fraud). This is a limited exception to the rule that a basis adjustment (rather than income) is available only for seller-financed debt. Alternatively, if IRC Sec. 108(e)(5) does not apply but the debt is qualified real property business debt, the taxpayer may be able to elect to exclude the debt discharge income under IRC Sec. 108(a)(1)(D).

Consumer Credit Card Debt Modification

Credit card debt default and delinquencies have risen in recent years. Late payments generally result in significant penalties and higher interest rates on the unpaid balances. As a result, the fees, penalties, and interest portion of a taxpayer's credit card balance may exceed the amount originally borrowed.

Applicable Exceptions to Income Recognition. No income is realized from the discharge of indebtedness to the extent that payment of the discharged liability would have resulted in a deduction. Since consumer credit card debt is generally nonbusiness, this rule is not likely to prevent the recognition of income when this debt is modified.

A purchase-money debt reduction for a solvent debtor is treated as a reduction of the purchase price rather than a cancellation of indebtedness. However, the Tax Court has rejected the application of this rule to the modification of consumer credit card debt for accumulated interest charges that were cancelled. Thus, unless a taxpayer is in bankruptcy or insolvent, a reduction in his credit card liability will result in income.

The Measure of Income Recognition. The Tax Court has held that a credit card company's forgiveness of defaulted interest is cancellation of debt (COD) income to the cardholder. Another Tax Court decision involving a loan transaction is equally applicable to credit card debt. The Court, in *Hahn, Jr.*, ruled that COD income includes not only a cancellation of principal, but also a cancellation of an obligation to pay interest, late charges, and attorneys' fees. Consequently, solvent credit card holders generally must include in income the full amount of any credit card debt reduction.

SELF-STUDY QUIZ

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

37. If a lender takes property in satisfaction of the borrower's recourse debt, it is treated as a deemed sale of the property. What is the character of the gain or loss, if any, on the deemed sale of the property?

    a. Same as the character of the property subject to foreclosure.

    b. Long-term capital asset.

    c. Short-term capital asset.

    d. Based on the length of time from the origination of the debt to the foreclosure date.

38. With regard to a foreclosure transaction involving nonrecourse debt, which of the following statements is correct?

    a. The amount realized from the deemed sale is equal to the fair market value of the property.

    b. The fair market value of the property is not a factor in the transaction.

    c. There will always be debt discharge income when the foreclosure involves nonrecourse debt.

39. When seller-financed debt of property that arose from the debtor's purchase of the property is reduced and certain conditions are met, the debtor reduces the basis of the property and does not recognize debt discharge income. Which of the following is **not** a condition that must be satisfied to apply this rule?

    a. The creditor is the original seller of the property.

    b. The debt arose from the debtor's purchase of the property.

    c. The debtor would recognize debt discharge income if it were not for this exception.

    d. The debtor must have owned the property for one year or less.

40. Chris sold an office building to Carrie for $1 million. Carrie signed an unsecured note payable to State Bank, a third-party lender, for the amount of $1 million. The price Carrie paid for the building was $100,000 more than should have been paid due to Chris's material misrepresentations to support a higher price. After the sale, the fair market value of the building was $900,000. State Bank agrees to reduce the amount of the Carrie's debt from $1 million to $900,000 due to the misrepresentations. How does Carrie treat the debt discharge for tax purposes?

    a. Purchase price reduction.

    b. Taxable income.

    c. Taxable loss.

    d. No tax consequences to the debt discharge.

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.)**

37. If a lender takes property in satisfaction of the borrower's recourse debt, it is treated as a deemed sale of the property. What is the character of the gain or loss, if any, on the deemed sale of the property? **(Page 301)**

    a. Same as the character of the property subject to foreclosure. [This answer is correct. According to IRS guidance, for the deemed sale, the proceeds are equal to the lesser of the FMV at the time of foreclosure or the amount of the secured debt. The character of the gain or loss on the deemed sale is the same as it would have been if the borrower had sold the property to a third party.]

    b. Long-term capital asset. [This answer is incorrect. According to IRS regulations and revenue rules, the character of gain or loss will not be treated as a long-term capital asset. Other treatment is required.]

    c. Short-term capital asset. [This answer is incorrect. Other treatment of the gain or loss is required under the guidance provided by the IRS regarding foreclosures by the lender.]

    d. Based on the length of time from the origination of the debt to the foreclosure date. [This answer is incorrect. The timing described above is not applicable to the determination of the character of gain or loss in the above scenario. The correct answer is found in the IRS revenue rules and regulations.]

38. With regard to a foreclosure transaction involving nonrecourse debt, which of the following statements is correct? **(Page 301)**

    a. The amount realized from the deemed sale is equal to the fair market value of the property. [This answer is incorrect. The fair market value is the amount realized for transactions involving recourse debt.]

    b. The fair market value of the property is not a factor in the transaction. [This answer is correct. As reflected in the out comes of various court cases, the amount realized on the deemed sale is the balance of the nonrecourse debt.]

    c. There will always be debt discharge income when the foreclosure involves nonrecourse debt. [This answer is incorrect. Since the full amount of the nonrecourse debt is treated as the amount realized, there can be no debt discharge income.]

39. When seller-financed debt of property that arose from the debtor's purchase of the property is reduced and certain conditions are met, the debtor reduces the basis of the property and does not recognize debt discharge income. Which of the following is **not** a condition that must be satisfied to apply this rule? **(Page 302)**

    a. The creditor is the original seller of the property. [This answer is incorrect. This condition is one of the three conditions listed in the Internal Revenue Code that is required to reduce the basis of the property.]

    b. The debt arose from the debtor's purchase of the property. [This answer is incorrect. This condition is one of the three conditions that is required by the Code to reduce the basis of the property.]

    c. The debtor would recognize debt discharge income if it were not for this exception. [This answer is incorrect. This condition is one of the three conditions that is required to reduce the basis of the property. Under the Code, the purchaser cannot be bankrupt or insolvent and must not have made a qualified real property debt election.]

    d. The debtor must have owned the property for one year or less. [This answer is correct. This is not a condition that must be met under the Code to reduce the basis of property when the seller-financed debt is reduced. The holding period of under the Code the property does not affect the mandatory requirement to reduce the basis of property.]

40. Chris sold an office building to Carrie for $1 million. Carrie signed an unsecured note payable to State Bank, a third-party lender, for the amount of $1 million. The price Carrie paid for the building was $100,000 more than should have been paid due to Chris's material misrepresentations to support a higher price. After the sale, the fair market value of the building was $900,000. State Bank agrees to reduce the amount of the Carrie's debt from $1 million to $900,000 due to the misrepresentations. How does Carrie treat the debt discharge for tax purposes? **(Page 302)**

    a. Purchase price reduction. [This answer is correct. According to the Code, debt discharge is treated as an adjustment to the purchase price (resulting in a reduction to basis) instead of income only if there is infirmity clearly relating back to the original sale such as misrepresentation or fraud by the seller.]

    b. Taxable income. [This answer is incorrect. Due to the misrepresentations made by the seller, the transaction qualifies for tax treatment other than taxable income to the buyer.]

    c. Taxable loss. [This answer is incorrect. The buyer has not suffered a taxable loss.]

    d. No tax consequences to the debt discharge. [This answer is incorrect. This transaction does have tax consequences, even though the seller misrepresented the facts.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TDBTG093)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. For individual taxpayers, business bad debts result in what type of loss?

    a. Short-term capital losses.

    b. Long-term capital losses.

    c. Ordinary losses.

    d. Nondeductible losses.

22. For individual taxpayers, nonbusiness bad debts result in what type of loss?

    a. Short-term capital losses.

    b. Long-term capital losses.

    c. Ordinary losses.

    d. Nondeductible losses.

23. When must a taxpayer deduct a totally worthless debt?

    a. Within three years of when it becomes totally worthless.

    b. Within two years of when it become totally worthless.

    c. Only in the tax year it becomes totally worthless.

    d. In any tax year after it becomes totally worthless.

24. On which tax form is a business bad debt deduction resulting from an employee-shareholder loan to a corporation reported?

    a. Schedule A (Form 1040).

    b. Schedule C (Form 1040).

    c. Schedule D (Form 1040).

    d. Schedule F (Form 1040).

25. The statute of limitations for tax refunds relating to nonbusiness bad debt losses is which of the following?

    a. Two years.

    b. Three years.

    c. Four years.

    d. Seven years.

26. For a nonbusiness bad debt deduction, the taxpayer must attach a statement to the tax return documenting the bad debt but is **not** required to disclose which of the following information?

    a. The source of the funds that were loaned.

    b. A description of the bad debt.

    c. The debtor's name and his or her relationship to the taxpayer.

    d. The collection efforts that were made and the reason the debt is considered wholly worthless.

27. A recovery of a nonbusiness bad debt from which a taxpayer received a tax benefit is treated as which of the following?

    a. Ordinary income.

    b. Long-term capital gain.

    c. Short-term capital gain.

    d. No income tax consequences.

28. For tax purposes, the cancellation or forgiveness of a debt results in which of the following for the solvent debtor unless certain exceptions apply?

    a. Tax loss.

    b. Taxable income.

    c. Tax benefit.

    d. No tax consequences.

29. When an existing debt is significantly modified to avoid default, the modification of the terms of the debt is considered an exchange of old debt for new debt and may give rise to debt discharge income. Which of the following would not result in debt discharge income?

    a. Modifying payment timing.

    b. Changing the security or obligor.

    c. Changing the debt instrument's nature.

    d. Applying an interest rate that equals or exceeds the AFR.

30. In order for forgiven debt be *qualified farm indebtedness*, what percentage of a taxpayer's gross receipts from all sources for the preceding three years must be attributable to the farming business?

    a. 100%.

    b. 80%.

    c. 50%.

    d. 20%.

31. A taxpayer who is not insolvent or bankrupt may exclude income from the discharge of qualified real property business debt if the taxpayer makes a valid election for the tax year the discharge occurs. What tax form does the taxpayer file for making this election?

    a. Form 4797.

    b. Form 982.

    c. Schedule C.

    d. Schedule E.

32. The cancellation of certain student loans which were made on the condition that the student fulfill a specific public service obligation are includible in gross income only if the loan is made by any of the following **except** which one?

    a. A major commercial bank that offers private student loans.

    b. A federal, state, or local government unit, or an instrumentality, agency, or subdivision of such.

    c. A tax-exempt public benefit corporation with control of a state, county, or municipal hospital, whose employees are considered public employees under state law.

    d. A qualified educational institution that makes the loan under an agreement with a qualified entity or under a program offered by the educational institution that is designed to encourage the students to serve in occupations or areas with unmet needs.

33. For taxpayers filing a 2009 joint tax return, the maximum aggregate amount of debt that can be treated as qualified principal residence indebtedness is which of the following?

    a. $200,000.

    b. $500,000.

    c. $1,000,000.

    d. $2,000,000.

34. Hank owes $5,000 to National Bank. He also has other liabilities of $7,000 and assets with a fair market value of $9,000. Hank is insolvent by $3,000 ($9,000 assets − $12,000 liabilities). National Bank discharges Hank's debt of $5,000 in return for a payment of $1,000. Hank realizes $4,000 ($5,000 − $ 1,000) of debt discharge income. What is the amount of taxable income that Hank must recognize?

    a. $4,000.

    b. $3,000.

    c. $1,000.

    d. $500.

35. Instead of reducing tax attributes in the order specified in the Internal Revenue Code, taxpayers who are bankrupt or insolvent can elect to first reduce which of the following?

    a. Capital loss carryovers.

    b. Foreign tax credit carryover.

    c. Basis of nondepreciable assets.

    d. Basis of depreciable assets.

36. If the basis in the bankrupt or insolvent taxpayer's property is reduced under the general attribute reduction ordering rules, the aggregate basis of the taxpayer's assets cannot be reduced below which of the following?

    a. Aggregate FMV of the taxpayer's assets immediately after the discharge.

    b. Aggregate FMV of the taxpayer's assets immediately before the discharge.

    c. Aggregate liabilities immediately after the discharge.

    d. Aggregate liabilities immediately before the discharge.

37. Joan transfers to a creditor an asset with a fair market value of $6,000, and the creditor discharges $7,500 of indebtedness for which Joan is personally liable. Joan has income from the discharge of indebtedness of $1,500. The deemed sale of the asset is for what amount?

    a. 7,500.

    b. $6,000.

    c. $1,500.

    d. $2,000.

38. When property is foreclosed on due to default on a nonrecourse debt, the foreclosure is treated as a deemed sale of the property by the borrower to the lender. For a cash-basis borrower, the amount realized from the deemed sale of the property is which of the following amounts?

    a. The fair market value of the property.

    b. The tax basis of the property to the borrower.

    c. The original balance of the nonrecourse debt.

    d. The current balance of the nonrecourse debt.

39. If debt to a seller of property that arose out of a debtor's purchase of the property meets certain conditions, which of the following describes the treatment by the debtor when the seller-financed debt is reduced?

    a. Recognize debt discharge income.

    b. Recognize gain on sale of property.

    c. Reduce the basis of the property.

    d. No tax consequences occur.

40. A taxpayer who is not insolvent or bankrupt can elect to exclude from gross income any income from the discharge of qualified real property business debt. The amount of qualified real property business debt discharge that can be excluded cannot exceed the lesser of two types of limitations. These two limitations are referred to as which of the following?

    a. AGI limitation and capital loss limitation.

    b. Basis reduction limitation and interest expense limitation.

    c. Special limitation and statute of limitations.

    d. FMV limitation and overall limitation.

GLOSSARY

Applicable Federal Rate (AFR): The IRS issues (via Revenue Rulings) prescribed rates each month to be used in determining if there is unstated interest. The AFRs are short-term, midterm, and long-term for each month with separate rates for annual, semiannual, quarterly, and monthly compounding.

Appreciated Financial Position: An appreciated financial position is any position relating to a stock, debt instrument, or partnership interest where there would be gain if the position were sold, assigned, or otherwise terminated at its FMV. "Position" means an interest, including a futures or forward contract, short sale, or option.

Average Basis Method: The average basis method may be used to determine the basis of mutual fund shares. This method may be computed using either the single-category method or the double-category method.

Bankrupt: Bankrupt means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 (of the U.S. Bankruptcy Code) case. Title 11 encompasses the federal bankruptcy statutes and includes Chapter 7 (liquidation), Chapter 11 (business reorganization), Chapter 12 (family farmer or fisherman), and Chapter 13 (adjustment of an individual's debts) bankruptcies.

Business Bad Debt: A bad debt arises from a debt created or acquired in the ordinary course of the taxpayer's business, such as an account receivable, or a worthless debt, the loss from which is incurred in the taxpayer's trade or business.

Call Option: An option giving the holder the right to buy at a set price on or before a specified date is referred to as a call option.

Capital Asset: A capital asset is any property except inventory, depreciable or real property used in the taxpayer's trade or business, specified literary or artistic property, business accounts or notes receivable, or certain U.S. publications.

Debt Discharge Income: Debt discharge income is the amount of the unpaid balance of the debt that is forgiven by the lender.

Double-category Method: When a taxpayer elects to use the average basis method to determine the basis of mutual fund shares, the basis may be calculated under the double-category method. Under this method, all shares of a particular mutual fund are divided (based on holding period) into two categories at the time each sale occurs: short-term and long-term. When a share is held for more than one year, the share (and its related tax basis) is transferred from the short-term to the long-term category. Average basis is calculated for each category when a share is sold.

First-in First-out (FIFO): FIFO is the method used to determine the basis and holding period of stock sold when a taxpayer does not or cannot specifically identify which shares of stock are sold. This method assumes the shares acquired first are sold first.

Forward Contract: A forward contract is a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

Holding Period: The period of time that a stock is held which generally begins on the day following the day of acquisition and ends on (and includes) the day of disposition.

Insolvency: For purposes of the debt discharge rules, insolvency is the amount of the excess of a taxpayer's liabilities over the fair market value of the taxpayer's assets immediately before the debt discharge.

Nonbusiness Bad Debts: Bad debts that do not qualify as business bad debts and are not gifts are nonbusiness bad debts.

Nonqualified Stock Options (NQSOs): An NQSO is any option that is not a qualified stock option, as defined in IRC Sec. 422. Generally, the excess of the stock's FMV when the option is exercised over the option price (i.e., the bargain element) is taxable as compensation in the year of exercise.

Offsetting Notional Principal Contract: An offsetting notional principal contract is an agreement that includes: (1) a requirement to pay all or substantially all of the investment yield (including appreciation) related to the property for a specified period, and (2) a right to be reimbursed for all or substantially all of any decline in the value of the property.

Partially Worthless Bad Debt: A debt of which the taxpayer can collect a portion but not all is a partially worthless bad debt.

Put Option: A publicly traded option giving the holder the right to sell a specified stock at a set price (the strike price) on or before a specified date is called a put option.

Qualified Covered Call Option: A qualified covered call option is any option a taxpayer grants to purchase stock he holds (or stock he acquires in connection with granting the option), but only if all of the following are true: (1) the option is traded on a national securities exchange or other market approved by the Secretary of the Treasury, (2) the option is granted more than 30 days before its expiration date, (3) the option is not a deep-in-the-money option, i.e., an option with a strike price lower than the lowest qualified benchmark (LQB), (4) the taxpayer is not an options dealer who granted the option in connection with his activity of dealing in options, and (5) gain or loss on the option is capital gain or loss.

Qualified Farm Indebtedness: Qualified farm indebtedness must meet the following conditions: (1) debt that was incurred directly in the business of farming; (2) at least 50% of the taxpayer's gross receipts from all sources, including farming, for the preceding three years were attributable to the business of farming; and (3) the lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality.

Qualified Principal Residence Indebtedness: Qualified principal residence Indebtedness is debt that meets the Section 163(h)(3)(B) definition of acquisition indebtedness for the residential interest expense rules, but only with respect to the taxpayer's principal residence (i.e., does not include second homes or vacation homes), and with a $2 million limit ($1 million for married filing separate taxpayers) on the aggregate amount of debt that can be treated as qualified principal residence indebtedness.

Qualified Real Property Business Debt: Qualified real property business debt includes debt (1) that was incurred or assumed in connection with real property used in a trade or business and that is secured by such real property; (2) that was incurred or assumed (a) before January 1, 1993, or (b) on or after January 1, 1993 and is qualified acquisition debt (i.e., debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business); and (3) with respect to which an election to invoke the special rules of IRC Sec. 108(a)(1)(D) has been made.

Qualified Small Business Stock (QSBS): QSBS is stock originally issued after August 10, 1993, by a C corporation with aggregate gross assets not exceeding $50 million at any time from August 10, 1993, to immediately after the issuance of the stock. The taxpayer must have acquired the stock at its original issue, or in a tax-free transaction such as a gift, inheritance, or partnership distribution. In addition, the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded.

Short Sale: A short sale occurs when a taxpayer borrows securities and then sells them. Economically, it amounts to a bet by the taxpayer that the price of the securities will decline. If it does, the securities can be bought (at the lower price) to replace those borrowed and sold short, and profit from the price difference.

Single-category Method: When a taxpayer elects to use the average basis method to determine the basis of mutual fund shares, the basis may be calculated under the single-category method. This method includes all shares of a particular mutual fund in a single account. Each share's basis is the total basis of all shares in the account at the time of the sale, divided by the number of shares.

Small Business Corporation: A corporation (either C or S) is treated as a small business corporation if, when stock (Section 1244 stock) is issued, the aggregate amount of money and other property it received in exchange for stock or as a contribution to capital or paid-in-surplus does not exceed $1 million. Thus, stock associated with the first $1 million of capital (i.e., capital stock and paid-in-capital) can qualify as Section 1244 stock.

Specific Identification Method: When less than the entire holdings of stock is sold, a taxpayer may use the specific identification method to determine the basis and holding period of stock sold by specifically identifying which shares were sold. Adequate identification must be made by the taxpayer.

Straddle: Holding a position [including an option to buy (other than a qualified covered call as described in IRC Sec. 1092) or sell] that substantially diminishes a taxpayer's risk of loss of holding property is a straddle.

Straight Debt: A straight debt is any position with respect to a debt if the position unconditionally entitles the holder to receive a specified principal amount. Interest payments are payable based on a fixed or variable rate, and the position cannot be converted (directly or indirectly) into stock of the issuer or any related person.

Tax Benefit Rule: 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.

Wash Sale: A wash sales occurs when if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities. Wash sales losses from the sale or disposition of stock or securities are generally not deductible.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook— Course 1—Form 1040 Supplemental Schedules C, F, & E (TDBTG091)

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.

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   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.

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   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.

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3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2010**. 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.

5. 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.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. 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 lesson, 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 onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	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.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: November 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 1—Form 1040 Supplemental Schedules C, F, & E

Course Acronym: TDBTG091

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?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
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?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 2—Personal Deductions (TDBTG092)

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.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment 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.

   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.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   TDBTG092 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   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.

   Please allow a minimum of three weeks for grading.

   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.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2010**. 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.

5. 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.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. 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 lesson, 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 onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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CPE Examination Questions (Lesson 3) 147

CPE Examination Questions (Lesson 4) 161

CPE Examination Questions (Lesson 5) 181

CPE Examination Questions (Lesson 6) 213

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1040 Deskbook—Course 2—Personal Deductions (TDBTG092)

CTEC Course No. 3039-CE-0225
Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	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.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: November 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 2—Personal Deductions Course Acronym: TDBTG092

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?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
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?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 3—Securities Transactions and Debt Transactions (TDBTG093)

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.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment 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.

   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.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   TDBTG093 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   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.

   Please allow a minimum of three weeks for grading.

   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.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2010**. 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.

5. 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.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. 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 lesson, 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 onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1040 Deskbook—Course 3—Securities Transactions and Debt Transactions (TDBTG093)

CTEC Course No. 3039-CE-0226
Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	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.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: November 30, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 3—Securities Transactions and Debt Transactions Course Acronym: TDBG093

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?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
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?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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