FILING YEAR 2020
FEDERAL INCOME TAX LAW

DESKBOOK

ADMINISTRATIVE AND CIVIL LAW DEPARTMENT

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

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CHAPTER A

INTRODUCTION TO FEDERAL INCOME TAXATION

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

I. REFERENCES

A. Internal Revenue Code of 1986 (I.R.C.).

B. Treasury Regulations (Treas. Reg.).

C. Home page for the Internal Revenue Service (www.irs.gov)

1. IRS Tax Topics, https://www.irs.gov/taxtopics.

2. Tax Information for Members of the Military, https://www.irs.gov/individuals/military.

D. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.

2. Pub. 17, Your Federal Income Tax.

3. Pub. 501, Dependents, Standard Deductions, and Filing Information

4. Pub. 504, Divorced or Separated Individuals

5. Pub. 555, Community Property.

6. Pub. 4012, VITA/TCE Volunteer Resource Guide.

E. IRS Form 1040 and Instructions.

F. William Kratzke, Basic Income Tax 2020-2021 Edition, Published by CALI eLangdell Press. Available under a Creative Commons BY-NC-SA 3.0 License. https://www.cali.org/books/basic-income-tax.

II. OVERVIEW

A. Federal tax burden of individual taxpayers.

1. The personal income tax is the largest source of federal tax revenues, accounting for approximately one-half of all receipts.

2. The second-largest source of federal revenue is payroll taxes, i.e., Social Security and Medicare taxes levied on the wages and self-employment income of individuals. Payroll taxes collectively account for approximately one-third of all federal receipts, and individuals pay one-half of this burden. (From an economic standpoint, they may pay even more; many economists and policy analysts argue that employers pass along the effective cost of their obligations to employees or consumers.)

3. Individual taxpayers thus bear the primary burden of funding the federal government's operations and programs.

B. Federal tax legislation is set forth in the Internal Revenue Code of 1986, contained in Title 26 of the United States Code. Title 26 is abbreviated as "I.R.C." See the Appendix for further discussion of the Internal Revenue Service (IRS) and sources of tax law cited throughout this Deskbook.

C. Conceptually, "income" means net increases to a taxpayer's wealth over the course of a year, without reduction for personal consumption expenses. Accordingly, income includes an individual's compensation received during the year for performing services. The same individual's income is not reduced for most personal expenses, such as food, clothing, and purchases of household items.

D. The Internal Revenue Code implements the income tax by broadly defining wealth increases as "gross income" and then allowing various "deductions" from this amount to determine the "tax base," which is "taxable income." The taxpayer's liability is based on the amount of his or her taxable income and various applicable tax rates. I.R.C. §§ 61(a), 63(a).

1. An individual's annual gross income is normally the trigger that obligates him or her to file a tax return for the year. The trigger amount varies according to the taxpayer's family circumstances, or "filing status."

2. Most individuals satisfy their tax filing obligations by submitting Form 1040 to the IRS on or before April 15 in the year succeeding that in which they earned the income. I.R.C. § 6012(a), 6072(a); Treas. Reg. § 1.6012-1(a)(6).

3. The tax rates in the Internal Revenue Code are progressive, meaning that they increase as the taxpayer's income increases. To determine a taxpayer's income tax liability, the Code divides taxable income into brackets and applies a particular rate to each bracket. For example, the taxpayer might pay tax at a rate of 10% for the first bracket, 15% for the next bracket, and so forth.

E. The "federal income tax formula" is a way to visualize the operation of the Internal Revenue Code. A simplified federal income tax formula follows:

	Gross Income
Less:	(Adjustments)
Equals:	Adjusted Gross income
Less:	(Deductions, including Exemptions)
Equals:	Taxable Income
Yields:	Tentative Income Tax
Less:	(Credits)
Plus:	Other Taxes
Equals:	Final Tax Liability

1. The federal income tax formula is not stated explicitly in the Internal Revenue Code, but instead depicts the operation of the Code's various statutory provisions.

2. IRS Form 1040 and accompanying forms and schedules correspond more closely to the federal income tax formula in implementing federal tax law.

F. "Deductions," as the federal income tax formula shows, are reductions of gross income. Tax laws permit deductions for various types of expenditures; these expenditures reduce the tax base and thus an individual's tax liability. Deductions, in theory, are allowed because they do not represent true increases in wealth. For example, an individual operating a business deducts the cost of inventory from his or her gross income. In practice, deductions also are allowed to encourage certain types of spending or to subsidize taxpayers who experience certain circumstances.

1. Certain deductions specified in I.R.C. § 62 are allowed regardless of the taxpayer's income. To distinguish these deductions from others, IRS forms and publications refer to Section 62 deductions as "Adjustments," although the Internal Revenue Code does not use this term. The term highlights how deductions from gross income yield "Adjusted Gross Income" or "AGI." AGI is an important reference point in determining an individual's tax liability.

2. Because all deductions deprive the government of tax revenue, many deductions are limited based on the taxpayer's income, filing status, or other considerations. Frequently, the limitation is based on AGI or some variant of AGI, such as Modified AGI or "MAGI." For this reason, adjustments (as opposed to deductions) include a number of deductions that Congress has determined should be allowed regardless of a taxpayer's individual circumstances, including business expenses (since they are necessary to produce income).

3. For most deductions other than adjustments, the taxpayer elects either (1) to claim the standard deduction, which is a fixed amount determined by the taxpayer's filing status; or (2) to itemize deductions. This step takes place after AGI is determined. If a taxpayer elects to itemize, he or she reduces AGI by specific expenditures that the Internal Revenue Code allows, such as home mortgage interest, state income tax, local property tax, and charitable contributions, rather than the standard deduction (the fixed amount) for his or her filing status.

4. Other than for years 2018 through 2025, the Code also permits a special deduction in a fixed amount, known as an "exemption," for the taxpayer and each member of his or her household. The taxpayer and the spouse are each entitled to a "personal exemption." For other household members, the taxpayer claims an "exemption for a dependent" or a "dependency exemption." Exemptions are gradually reduced (i.e., they "phase out") for higher-income taxpayers.

5. Ignoring AGI-based or taxpayer-specific limitations, the value of a deduction is the stated amount of the deduction multiplied by the applicable tax rate. For example, if a taxpayer has to pay tax at a rate of 30% and qualifies for a deduction of $1,000, the value of the deduction is $300. This is because the taxpayer lowered his or her income by $1,000 and, without the deduction, would have paid tax on an additional $1,000 of income at a rate of 30%. Accordingly, the benefit of the deduction equals the tax savings of $300.

G. The federal tax laws implement legislative spending goals by allowing "credits" against income tax, which are reductions of an individual's tax liability in lieu of a payment to that individual. *See, e.g.,* I.R.C. §§ 21–53.

1. The stated amount of a credit is more valuable than the stated amount of a deduction. This is because a credit directly reduces an individual's tax liability, while a deduction reduces the liability only indirectly by reducing the amount of income multiplied by the tax rate. Accordingly, a $1,000 credit is worth $1,000.

2. For this reason, the Internal Revenue Code typically places strict limits upon tax credits and restricts qualifying taxpayers to those whose income is within or below certain levels or who make expenditures that the law specifically seeks to encourage.

3. Moreover, many tax credits are non-refundable. In other words, if the taxpayer's tax liability is too low to exhaust the value of the credit, the taxpayer does not receive the excess. In that scenario, the value of a credit does not strictly conform to the rule just stated. For example, if a taxpayer qualifies for a $1,000 non-refundable credit, but has a tax liability of only $700, the value of the credit is only $700 for that taxpayer.

4. Accordingly, refundable credits are especially valuable to taxpayers who qualify for them. The Internal Revenue Code treats them as payments to the IRS, which are owed to the taxpayer if they exceed his or her tax liability.

H. In complying with the federal tax laws, the biggest challenge faced by most taxpayers is to determine the set of adjustments, deductions, and credits that apply.

III. WHEN TO FILE

A. Individual taxpayers generally must file Form 1040 based upon income earned in the calendar year, i.e., January 1 to December 31. Calendar-year tax returns are normally due on April 15 of the succeeding year. I.R.C. § 6072(a); Treas. Reg. § 1.6072-1(a).

B. If April 15 falls on a Saturday, Sunday, or legal holiday, the return is deemed timely if filed on the next day that is not a weekend or holiday. I.R.C. § 7503.

1. "Legal holiday" generally means a legal holiday in the District of Columbia or, where an act is to be performed in certain defined geographic regions, a state-wide legal holiday. I.R.C. § 7503.

2. Therefore, Emancipation Day in the District of Columbia and Patriots Day or similar holidays in certain states may extend the filing date beyond the first business day following a weekend or holiday. For example, as the IRS concluded in Rev. Rul. 2015-13, 2015-22 I.R.B. 1011, for calendar year 2015:

a. April 15, 2016 fell on a Friday, a normal business day. However, that year, Emancipation Day took place that year on Saturday, April 16. As a result, the District of Columbia celebrated this holiday on Friday, April 15.

b. Under Section 7503, the District of Columbia holiday had nationwide impact. Most taxpayers had until Monday, April 18 to file a tax return.

c. Furthermore, in Massachusetts and Maine, April 18 was Patriots Day, a state-wide legal holiday in both states. Taxpayers residing in those states could file as late as Tuesday, April 19.

d. The IRS publishes annual guidance on due dates for individual tax returns.

3. Mailbox rule. In general, a taxpayer "files" a return on the date the IRS receives it. *See, e.g., Estate of Wood v. Comm'r*, 909 F.2d 1155, 1159 (8th Cir. 1990). The mailbox rule provides a limited exception to the

general rule. Under the mailbox rule, a return is deemed received by the IRS on the post-marked date, even if the IRS actually receives the return later. *See* Treas. Reg. § 301.7502-1.

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

1. An automatic 6-month extension is available to file an individual income tax return. Form 4868.

   a. Taxpayers should file Form 4868 to claim an extension, which requires the taxpayer to estimate his or her tax liability.

   b. Note the IRS grants an automatic 6-month extension if the taxpayer pays part or all of his or her estimated tax liability using a credit or debit card or by making a direct transfer from a bank account by telephone or over the internet. See Form 4868 Instructions.

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

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

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

5. Note. If the taxpayer owes money and files a Form 4868 with no payment, the IRS may assess a failure-to-pay penalty of 0.5% per month plus interest, up to a maximum of 25% of the tax liability. This penalty is not assessed where the taxpayer pays 90% or more of the tax liability at the original due date and pays the remaining balance with the filed return. In aggravated circumstances (such as where the taxpayer grossly understates the estimated tax liability without a reasonable explanation), the IRS may void the extension and assess the taxpayer with a late-filing

penalty (5% per month) on the tax owed, up to a maximum of 25% of the liability.

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

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

2. The taxpayer attaches a statement to the return explaining the qualifying circumstances for the extension.

3. If a taxpayer uses the overseas extension and waits to pay the tax due, je or she must pay interest from the regular filing date at a daily compounded rate.

E. Amended returns.

1. A taxpayer may amend a prior tax return by filing Form 1040-X. Form 1040-X requires that the taxpayer show original and corrected amounts and may require attaching various supplemental schedules or supporting documents. Normally, submitting the original return is not required.

2. Taxpayers may file amended returns to correct errors, to make certain elections that were not made in the original return, or to take advantage of tax benefits that are made retroactive.

a. For example, a taxpayer should amend a return if he or she realizes that income was omitted or deductions were misstated.

b. A taxpayer may also file an amended return to itemize deductions instead of claiming the standard deduction.

(1) Note. A taxpayer is not permitted to change any election; a married taxpayer, for example, generally may not amend a tax return to file separately instead of jointly.

3. A taxpayer must file a claim for credit or refund within three years from the filing date of the return or two years from the date the tax was paid, whichever is later. I.R.C. §§ 6402(a), 6511(a) & (b)(1) (authorizing the Secretary of the Treasury to allow claims for overpayment or refund and setting applicable timeframes)

   a. Most taxpayers have three years from the original due date (normally 15 April) to file a request for refund. If 15 April for any year falls on a holiday or weekend, then the original due date is the next working day. I.R.C. § 7503.

   b. A return filed before the due date is deemed filed on the due date. I.R.C. § 6513(a) ("For purposes of section 6511, any return filed before the last day prescribed for the filing thereof shall be considered as filed on such last day."). Thus, a taxpayer who files a tax return on 1 February 20X2 is deemed to have filed it on 15 April 20X2 for statute of limitations purposes. The taxpayer may file an amended return as late as 15 April 20X5 for tax year 20X1.

   c. Note. The extended due date under Section 7503 will not extend the due date for a refund claim if the originally filed return does not actually take advantage of the Section 7503 extension. By its terms, Section 7503 apples only if a return is actually filed on the next succeeding day in question. I.R.C. § 7503 ("When the last day prescribed … for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely *if it is performed* on the next succeeding day which is not a Saturday, Sunday, or a legal holiday.") (emphasis added). For example, if 15 April 20X2 is a Saturday, and the taxpayer files on Friday, 14 April (and not Monday, 17 April), the return is deemed filed on Saturday, 15 April under Section 6513. Accordingly, any refund claim for Year 1 must be made by 15 April 20X4, not 17 April 20X4 (because Section 7503 was not applicable to the original return). Rev. Rul. 2003-41, 2003-17 I.R.B. 814.

IV. WHO MUST FILE A RETURN

A. Whether a taxpayer has to file a tax return depends on:

1. Gross income.

a. Under I.R.C. § 61, "gross income" includes "all income from whatever source derived" that is not otherwise excluded by other provisions.

b. If a taxpayer is married and permanently resides in a community property state, half of any income described by state law as community income (this generally includes each spouse's wages) may be considered the taxpayer's income.

c. Gross income for determining the taxpayer's filing requirement under I.R.C. § 6012 (see below) includes both (1) gain that is excludable on the sale of a residence under I.R.C. § 121 and (2) foreign earned income excludable under I.R.C. § 911. I.R.C. § 6012(c); Treas. Reg. § 1.6012-1(a)(3).

2. Filing status.

a. The gross income is higher or lower depending on the taxpayer's marital status and family situation (discussed in more detail below).

3. Age.

a. The gross income threshold is higher for taxpayers over age 65. I.R.C. § 6012(A)(1)(b).

b. Taxpayers are considered 65 on the day before their 65th birthday. Pub. 17 (Part One – The Income Tax Return – Filing Information).

B. Generally, an income tax return must be filed by every individual United States citizen and resident alien who has gross income that equals or exceeds specified amounts. I.R.C. § 6012(a); Treas. Reg. § 1.6012-1(a).

1. See Pub. 17, Table 1-1 for the thresholds based on age and filing status.

2. The filing threshold amount for an individual is generally the sum of the individual's personal exemption and standard deduction amounts. I.R.C. § 6012(a). Income below this amount normally would result in no tax due. However, even when the gross income test is not met, a return should be filed whenever a refund of tax or a refundable tax credit (such as the earned income tax credit or the additional child tax credit) is available.

3. For tax years 2018 through 2025, the personal exemption amount equals zero. Refer to I.R.C. § 6012(f) instead of Section 6012(a) for the applicable gross income test

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

1. The income threshold for filing a tax return is generally lower for an individual who may be claimed as a dependent on another's tax return. The Internal Revenue Code reduces the exemption amount and standard deduction allowable to these taxpayers. I.R.C. § 63(c)(5). The threshold depends on whether the individual has earned income (e.g., wages and self-employment) or unearned income (e.g., interest and dividends).

a. See Pub. 17 (Table 1-2, Filing Requirements for Dependents).

b. Table 1-2 specifies separate filing thresholds for children or other dependents based on the limited standard deduction that the Internal Revenue Code allows for these individuals.

(1) Under Section 63(c)(5), the standard deduction is limited to the greater of (1) $500, adjusted annually for inflation; or (2) $250, adjusted annually for inflation, plus the individual's *earned* income.

(2) Example. Using statutory, non-inflation-adjusted amounts, assume a teenager lives with his or her parents and earns

$2,000 in wages at a summer job. Assume that the standard deduction for most individuals is $3,000. I.R.C. § 63(c)(2)(C). Under Section 63(c)(5) & (c)(5)(B), the individual's standard deduction is limited to $2,250 ($250 plus earned income of $2,000).

c. A child or dependent must file a return if that individual's:

(1) Unearned income exceeds the amount established under Section 63(c)(5)(A), i.e., the statutory amount of $500 adjusted annually for inflation; or

(2) Gross income exceeds the standard deduction for that individual. In the above example, the teenager would have a filing obligation if his or her gross income exceeds $2,250 (non-inflation-adjusted amount).

d. Note. A parent may elect to include on the parent's return the unearned income of a child if the child: (*i*) is under age 19, or 24 if a full-time student; (*ii*) had no earned income; (*iii*) received unearned income (interest and dividends) in an amount less than the amount under I.R.C. § 63(c)(5)(A) (published annually); (*iv*) and made no estimated tax payments. If this election is made, then the child does not need to file a tax return. I.R.C. § 1(g)(7)(A) and (g)(7)(B)(ii).

(1) See Form 8814 and accompanying instructions for more detail.

(2) Practice note. In general, this election is not advantageous and will result in an overall increase in tax liability; typically, the parent has a higher marginal tax rate than the dependent.

D. Other situations may trigger a filing requirement even if the gross income threshold is not met, e.g., taxes owed on wages paid to household employees. For more details, see Pub. 17, Table 1-3. These situations are less common, and

Service members will normally be required to file based on their gross income and filing status.

E. Deceased individuals.

1. A final income tax return must be filed for a deceased person who would need to file for the portion of the year he or she was alive. I.R.C. § 6012(b)(1).

2. The executor, personal representative, administrator, or other legal representative is responsible for filing the tax return. If an executor or personal representative has not been appointed, the surviving spouse may file a joint return. I.R.C. §§ 6012(b)(1), 6013(a)(3).

a. The filing status of a surviving spouse is determined as of the last day the decedent was alive; if the decedent and surviving spouse were married on that day and they would file a joint return, the surviving spouse's filing status for the year of death is married filing jointly and not surviving spouse/qualified widow(er).

V. DEPENDENTS

A. To determine a taxpayer's filing status and to qualify for other tax benefits, the taxpayer must establish whether a family member or other individual qualifies as a "dependent." A "dependent" is someone who bears a certain relationship to the taxpayer and who lives with or receives support from the taxpayer.

B. Before and after tax years 2018 through 2025, the Internal Revenue Code allowed, and is set to again allow, a deduction in a fixed amount for the taxpayer and each member of his or her household. I.R.C. § 151.

1. The taxpayer and his or her spouse are each entitled to a "personal exemption." The deduction for a child or other dependent is a "dependency exemption."

a. Note. A spouse is *not* a dependent.

2. The dependency exemption is a statutory amount of $2,000, adjusted for inflation. I.R.C. § 151(d)(1), (4). The IRS publishes this amount each year. The deduction phases out for higher-income taxpayers.

3. For tax years 2018 through 2025, the exemption amount is zero. I.R.C. § 151(d)(5)(A). Nevertheless, the concept of a "dependent" remains important for determining filing requirements, filing status, and qualification for other federal tax benefits. I.R.C. § 151(d)(5)(B); I.R.S. Notice 2018-70, 2018-38 I.R.B. 441.

C. Under I.R.C. § 152, a dependent is either a Qualifying Child or a Qualifying Relative.

1. Exceptions:

a. A taxpayer cannot claim as a dependent an individual who himself or herself claims dependents. I.R.C. § 152(b)(1).

b. A taxpayer may not claim a dependent who has filed a joint return with another individual. I.R.C. § 152(b)(2).

c. A taxpayer's dependent must be a citizen or resident of the United States or a country contiguous to the United States. I.R.C. § 152(b)(3)(A).

(1) Contiguous countries include only Canada or Mexico. *See* Treas. Reg. § 1.152(a)(1).

(2) This rule does apply to adopted children who reside with the taxpayer, who himself or herself is a United States citizen or national. I.R.C. § 152(b)(3)(B).

2. Note. Internal Revenue Code provisions other than Section 152 frequently relax or restrict the Section 152 definition to meet legislative objectives. For example, the Section 152 definition provides that a qualifying child must be under age 19 (or a full-time student under age 24) and a resident of either the United States or a contiguous country. However, to qualify for the child tax credit under I.R.C. § 24, a taxpayer's qualifying child

must be under age 17 and must reside within the United States (a contiguous country does not qualify). I.R.C. § 24(c)(1)-(2).

3. Definition of qualifying child. I.R.C. § 152(c).

a. Relationship. I.R.C. § 152(c)(1)(A).

(1) Biological or adopted child, stepchild, foster child, or a descendant of these; or

(2) Sibling, stepsibling, half-sibling, or descendant of these.

b. Principal place of abode. I.R.C. § 152(c)(1)(B). The child must have the same principal place of abode of the taxpayer for more than one-half of the year.

c. Age. I.R.C. § 152(c)(1)(C). Child must be younger than the taxpayer and:

(1) Be under age 19 by the close of the year [I.R.C. § 152(c)(3)(A)];

(2) Be a full-time student for at least five calendar months of the year at a qualified educational institution (or qualified on-farm training program) and be under age 24 by the close of the year [I.R.C. § 152(c)(3)(B)]; or

(3) Be totally and permanently disabled [I.R.C. § 152(c)(1)(C), (c)(3), (f)(2)].

d. Support. The child must not provide more than one-half of his or her own support. I.R.C. § 152(c)(1)(D).

(1) As a practical matter, the support threshold normally does not require computations, e.g., where a child who lives with parents and unquestionably relied on them for more than half of his or her support.

(2) In closer cases, see Pub. 501, Worksheet 2. In analyzing this issue, note "support" includes "food, shelter, clothing, medical and dental care, education, and the like," as well as the fair market value of "property or lodging." Treas. Reg. § 1.152-1(a)(2)(i); Rev. Rul. 58-302, 1958-1 C.B. 62. It also includes "travel and recreation expenses." Pub. 501, Worksheet 2. In addition:

(a) Social Security payments received by a dependent and expended for the dependent's support are deemed to be support contributed by the dependent.

(b) State and local welfare benefits received by a dependent do not count as support contributed by the dependent; however, these funds constitute third-party support included within total support from all sources.

(i) The distinction between Social Security and welfare is that the former is based on earnings and contributions to the Social Security system, while the latter is based on need.

(c) Scholarships received by a dependent do not count as funds provided by the dependent. Treas. Reg. § 1.152-1(c).

e. Joint Return. The child must not have filed a joint return, unless such return is solely a claim for refund (i.e., to recoup taxes withheld from wages or payments of estimated tax from an individual with no tax liability). I.R.C. § 151(c)(1)(E).

4. Tie-Breaker Rules. I.R.C. § 152(c)(4).

a. Under the above tests, more than one taxpayer may qualify to claim an individual as a qualifying child (e.g., a grandparent and parent both living in a home with the same child).

b. The following rules are used in the event of multiple, eligible taxpayers:

(1) If both eligible taxpayers are parents, the parent with whom the child resided for the longer time period claims the child. I.R.C. § 152(c)(4)(B)(i).

(2) If both eligible taxpayers are parents and the child resided with the parents for the same amount of time, the parent with higher AGI claims the child. I.R.C. § 152(c)(4)(B)(ii).

(3) If only one eligible taxpayer is a parent, the parent claims the child. I.R.C. § 152(c)(4)(A)(i).

(4) If no eligible taxpayer is a parent, individual with the highest AGI claims the child. I.R.C. § 152(c)(4)(A)(ii).

(5) If the parents are eligible taxpayers, but choose not to claim the child as a dependent, another taxpayer may the individual as a dependent, but only if that other taxpayer's AGI is higher than that of any parent. I.R.C. § 152(c)(4)(C).

5. Definition of qualifying relative. I.R.C. § 152(d).

a. Not a qualifying child. I.R.C. § 152(d)(1)(D). Must not be a qualifying child of the taxpayer or any other taxpayer.

(1) The IRS concluded that "any other taxpayer" does not include an individual who is not required to file a tax return and who either (*i*) does not file a return or (*ii*) files a tax return solely to recoup withheld tax. I.R.S. Notice 2008-5, 2008-1 C.B. 256.

b. Relationship. I.R.C. § 151(d)(1)(A), (d)(2). The relationship test for a qualifying relative is broader than that for a qualifying child and includes the following:

(1) Biological or adopted child, stepchild, foster child, or a descendant of any of these;

(2) Sibling, half-sibling, or descendent of either;

(3) Father, mother, or ancestor or sibling either (i.e., grandmother, grandfather, aunt and uncle), but not foster parent;

(4) Stepfather or stepmother;

(5) Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or

(6) Any individual who lives with the taxpayer for the full year as a member of the taxpayer's household.

c. Gross Income. I.R.C. § 152(d)(1)(B). Dependent must earn less than the exemption amount.

(1) As noted, the exemption amount is a statutory amount of $2,000, adjusted for inflation, which the IRS publishes annually. I.R.C. § 151(d)(1), (4).

(2) Because the exemption amount for years 2018 through 2025 is zero, the IRS publishes a notional exemption amount for purposes of the gross income test. I.R.S. Notice 2018-70, 2018-38 I.R.B. 441.

d. Support. I.R.C. § 152(d)(1)(C). The taxpayer must furnish over one-half of the dependent's support.

(1) Multiple support agreements. I.R.C. § 152(d)(3). If two or more people together pay over half the support of an individual, but no one person alone pays more than half, one of the payors may be treated as having provided over half of such support as long as:

(a) The taxpayer otherwise qualifies to claim the individual as a dependent, but for the support test [I.R.C. § 152(d)(3)(B)];

(b) The taxpayer paid over 10% of the total support [I.R.C. § 152(d)(3)(C)]; and

(c) Each person who contributes over 10% of total support submits a written declaration that he or she will not claim the individual in question as a dependent beginning in that year. I.R.C. § 152(d)(3)(E); IRS Form 2120.

D. To claim a dependent on a tax return, the taxpayer must provide the dependent's taxpayer identification number. I.R.C. § 151(e).

1. Normally, this must be a Social Security number (SSN).

2. If the dependent does not have and does not qualify for an SSN because he or she is a resident or nonresident alien, the dependent must apply for an individual taxpayer identification number (ITIN) on Form W-7, Application for IRS Individual Taxpayer Identification Number.

3. If the dependent is an adopted child who cannot get an SSN, the taxpayer must apply for an adoption tax identification number (ATIN) on Form W-7A, Application for Taxpayer Identification Number for Pending U.S. Adoptions.

E. Divorced or Separated Taxpayers. I.R.C. § 152(e).

1. In general, the custodial parent is entitled to the exemption.

2. The noncustodial parent may claim an individual as a qualifying child or a qualifying relative in the following circumstances:

a. The child received over one-half of support from his or her parents [I.R.C. § 152(e)(1)(A)];

b. The parents are divorced or legally separated under a decree of divorce or separate maintenance, are separated with a written separation agreement, or lived apart at all times for the last six months of the year [I.R.C. § 152(e)(1)(A)(i)-(iii)];

c. One or both parents have custody for more than one-half of the year [I.R.C. § 152(e)(1)(B)]; and

d. The custodial parent releases his or her claim to the dependent on Form 8332 or prepares a written declaration containing equivalent information, and the noncustodial parent attaches that document to his or her return. I.R.C. § 152(e)(2)(A)-(B).

(1) Different documentation is required for pre-1985 and pre-2009 decrees. See Pub. 501 for these scenarios.

3. The custodial parent's release operates only to allow the noncustodial to claim the child for purposes of the child tax credit or the credit for other dependents. I.R.C. § 24. The release does <u>not</u> allow the noncustodial parent to claim any of the following: (1) head of household filing status with a dependent child; (2) the credit for child and dependent care expenses; (3) the income exclusion for dependent care benefits; (4) the health coverage tax credit, or (5) the earned income credit. I.R.S. Notice 2006-86, 2006-41 I.R.B. 680; Pub. 501 (Dependents – Qualifying Child of More than One Person).

VI. FILING STATUS

A. A taxpayer's filing status is based upon his or her family arrangements and other circumstances. Filing status impacts tax rates, tax brackets, the amount of the standard deduction, and qualification for various tax benefits. The taxpayer's filing status is one of the following: (1) Single, (2) Head of Household, (3) Married Filing Jointly, (4) Married Filing Separately, or (5) Qualifying Widow(er) or Surviving Spouse.

B. Single (S).

1. This is the default filing status and applies to anyone who does not qualify for another status by virtue of marriage or other family circumstances.

2. Single status is not elective. Except in narrow circumstances (discussed below under Head of Household status), a legally married person must use a filing status applying to a married individual.

3. The taxpayer's marital status is determined at the end of the tax year and is not pro-rated for any portion of the year. Specifically, a taxpayer married at any time during the year will file as a Single taxpayer if, by the close of the tax year, the taxpayer is "legally separated" under a final "decree of divorce or … separate maintenance." I.R.C. § 7703(a)(2).

   a. By "legally separated," i.e., a decree must "expressly and affirmatively provide that the parties [will] live apart in the future," thereby "alter[ing] the original and normal marital relationship." *Boettiger v. Comm'r*, 31 T.C. 477, 483 (1958) (concluding that a state decree of separate maintenance was not a "legal separation" because it imposed only a financial support obligation); *Capodanno v. Comm'r*, 69 T.C. 638 (1978), *aff'd*, 602 F. 2d 64 (3d Cir. 1979) (same).

   b. Voluntary separation under a written separation agreement does not constitute "legal separation." Treas. Reg. § 1.7703-1(a) Ex. 1; *see also Kellner v. Comm'r*, 468 F.2d 627 (2d Cir. 1972), *aff'g per curiam*, T.C. Memo. 1971-103, 30 T.C.M. (CCH) 448; *Johnson v. Comm'r*, T.C. Memo 1980-9, 39 T.C.M. (CCH) 868.

4. Annulments.

   a. A decree of annulment establishing that no valid marriage ever existed requires the taxpayer to file using Single status. *See* Rev. Rul. 76-255, 1976-2 C.B. 40.

   b. The IRS instructs the taxpayer to amend any returns still open under the statute of limitations (generally three years) and encompassed within the annulment decree. Pub. 17, Filing Status, Marital Status.

C. Married Filing Separately (MFS).

1. If the taxpayer is legally married on 31 December, he or she generally must decide whether to file separate return or to elect to file a joint return with his or her spouse. If the taxpayer does not elect the latter, the proper filing status is Married Filing Separately.

2. An MFS taxpayer reports only his or her share of income and other tax items.

3. Determination of marriage.

a. For a marriage within the United States, federal tax law recognizes a marriage of two individuals if it is recognized by the state, possession, or territory in which the marriage occurred. Treas. Reg. § 301.7701-18(b)(1).

(1) Case law and longstanding practice accords with the rule that marriage is determined under state or other applicable law. *See, e.g.*, *Untermann v. Comm'r*, 38 T.C. 93, 95 (1962); *Nicholas v. Comm'r*, T.C. Memo. 1991-393, 62 T.C.M. (CCH) 467 (analyzing state law to determine if taxpayer qualified for exemptions).

(2) Accordingly, a common law marriage is valid for federal tax purposes if recognized by the state or relevant jurisdiction. Rev. Rul. 58-66, 1958-1 C.B. 60.

(a) Federal tax law continues to recognize such a marriage, even if the taxpayer later resides in a jurisdiction that does not recognize common law marriage. Rev. Rul. 58-66, 1958-1 C.B. 60.

b. A marriage outside the United States is valid for tax purposes if at least one state, possession, or territory would recognize it. Treas. Reg. § 301.7701-18(b)(2).

c. Same-sex marriages are recognized as lawful marriages for all purposes.

(1) In *Windsor v. United States*, 570 U.S. 744 (2013), the Court struck down section 3 of the Defense of Marriage Act, 1 U.S.C. § 7, which had precluded the IRS from recognizing same-sex marriage for federal tax purposes.

(2) After *Windsor*, the IRS ruled that it would interpret the terms "spouse," "husband," and "wife" in a gender-neutral fashion to include same-sex marriages. Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

(3) The Supreme Court ruled in *Obergefell v. Hodges*, 576 U.S. 644 (2015), that all states must permit and must recognize same-sex marriages.

(4) In September 2016, the IRS promulgated regulations implementing *Windsor*, *Obergefell*, and Rev. Rul. 2013-17. Treas. Reg. § 301.7701-18 (cited above); T.D. 9785, 2016-38 I.R.B. 361 (Sept. 19, 2016).

d. Individuals are unmarried for federal tax purposes if they are in a civil union, domestic partnership, or similar arrangement that is not a marriage under state or applicable law. Treas. Reg. § 301-7701-18(c).

4. Married Filing Separately status is generally disadvantageous for married taxpayers. For example:

a. Many tax benefits, including the child and dependent care credit, education credits, the earned income credit, and the student loan interest deduction, are unavailable to MFS filers. I.R.C. §§ 21(e)(2), 25A(g)(6), 32(d), 222(d)(4).

b. If one spouse itemizes deductions, both must itemize. I.R.C. § 63(c)(6)(A). In other words, if one spouse has low deductible expenses, the spouse may lose the ability to claim the standard deduction if the other spouse elects to itemize.

5. Normally, married taxpayers should file separately only if:

   a. They are unable to agree upon a joint return; or

   b. Non-tax circumstances make joint and several tax liability undesirable.

D. Married Filing Jointly (MFJ). I.R.C. § 6013.

1. Taxpayers elect MFJ status by claiming such status on a tax return and aggregating their income and other tax items.

2. Subject to certain limitations for innocent spouses, the spouses are jointly and severally liable for the reported tax liability on a joint tax return. I.R.C. §§ 6013(d)(3), 6015.

3. The marriage determination is made at the close of the year or the last day the taxpayer or spouse was alive, whichever is earlier. Therefore, if one or both spouses die during the year, the proper filing status for the year of death is MFJ and <u>not</u> Qualifying Widow(er), a separate filing status discussed below. Treas. Reg. § 1.6013-1(d)(1).

   a. If a surviving spouse remarries before the close of the year, that spouse may not file MFJ with the deceased spouse. Treas. Reg. § 1.6013-1(d)(2).

4. MFJ status is generally unavailable if one spouse is a nonresident alien. However, the nonresident alien spouse may elect to be treated as a United States resident for the entire year, in which case his or her worldwide income generally becomes subject to United States taxation. I.R.C. § 6013(g)(1)-(2); Treas. Reg. § 1.6013-6(a); Pub. 519, U.S. Tax Guide for Aliens (Nonresident Alien or Resident Alien?).

   a. Where the spouses make this election, they must file a joint return for the year of the election, but thereafter may file separate returns. Treas. Reg. § 1.6013-6(a)(4)(i) & (c) Ex. 1.

E. Head of Household (HOH). I.R.C. § 2(b).

1. Where a taxpayer meets the requirements to file as Head of Household (HOH), this filing status offers favorable tax rates, a larger standard deduction, and eligibility for tax benefits unavailable to Single or MFS taxpayers.

2. To qualify as a HOH, the taxpayer must satisfy all of the following (the statutory rules are complex and summarized in Pub. 501, Table 4):

a. The taxpayer cannot be a nonresident alien at any time during the year, nor be a surviving spouse under I.R.C. § 2(a). I.R.C. § 2(b)(1), (b)(3)(A).

b. The taxpayer must be: (*i*) unmarried, (*ii*) married to a nonresident alien who was such at any time during the year, or (*iii*) considered unmarried under I.R.C. § 7703 (see below). I.R.C. § 2(b)(1), 2(b)(2)(B), 2(c).

c. The taxpayer must maintain a household. I.R.C. § 2(b)(1)(A)-(B).

(1) By "maintaining a household," the taxpayer must furnish more than one-half the cost of maintaining the household. I.R.C. 2(b) (flush language).

(a) The costs of maintaining a household are those "incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants" for the year. Treas. Reg. § 1.2-2(d).

(i) Costs specifically included are "property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises." Treas. Reg. § 1.2-2(d).

(ii) Costs specifically excluded are "clothing, education, medical treatment, vacations, life

insurance, and transportation," as well as the value of services rendered in the household by the taxpayer or by the dependent in question purportedly qualifying the taxpayer for HOH status (see next). Treas. Reg. § 1.2-2(d)

d. The household must be one of the following: (*i*) the home of the taxpayer and constitute for more than one-half of the year the principal place of abode for certain qualifying persons (specified below); or (*ii*) the principal place of abode of the taxpayer's father or mother, if the father or mother qualifies as a dependent.

(1) *Test (i)*. The following persons qualify a taxpayer for HOH status. I.R.C. § 2(b)(1)(A).

(a) Unmarried qualifying child, as defined by I.R.C. § 152(c) and without regard to I.R.C. § 152(e), which modifies subsection (c) in the case of divorced or separated parents [I.R.C. § 2(b)(1)(A)(i)].

(i) In other words, the custodial parent may file HOH even if he or she relinquishes to the noncustodial parent the right to claim the child as a dependent for purposes of the dependency exemption (if applicable) and the child tax credit. As noted above, the noncustodial parent cannot file HOH (or claim the earned income credit or other specified tax benefits).

(ii) Note the reference to I.R.C. § 152(c), which does not incorporate the "exceptions" stated subsection (b). Subsection (c) requires that the child meet certain relationship requirements, have the same principal place of abode as the taxpayer, meet certain age requirements, not provide over one-half of his or her support, and not file a joint return with any other individual (other than a return to claim a refund because the child

has no tax liability). This reference to subsection (c), as shown next, is significant where the child is married.

(b) Married qualifying child, but not if the child falls within the exceptions stated in I.R.C. § 152(b)(2) and (b)(3), namely, (*i*) a child who files a joint return with another individual; or (*ii*) a child who is not a United States citizen, national, or contiguous-country resident [I.R.C. § 2(b)(1)(A)(i)(I)-(II)].

(c) Married qualifying child, where the only reason the taxpayer cannot claim the child is because the taxpayer could be claimed as a dependent by different taxpayer.

(i) This result is noted in Pub. 501, Table 4, and results from the complicated interaction of I.R.C. §§ 2 and 152. Under Section 2(b)(1)(A)(i)(II), a taxpayer may not use as the basis for HOH status a married qualifying child falling within the Section 152(b)(2) and (b)(3) exceptions. However, Section 2 does not incorporate the exception stated in Section 152(b)(1), i.e., the exception that normally prevents a taxpayer from claiming a dependent if the taxpayer himself or herself could be claimed by someone else. As a result, even if the taxpayer can be claimed as a dependent by another person, that circumstance does not prevent the taxpayer from using a married qualifying child as the basis to file HOH.

(d) Any other dependent, i.e., a qualifying relative as defined under I.R.C. § 152(a)(2), but not a qualifying relative who satisfies the definition only for either of the following reasons [I.R.C. § 2(b)(3)(B)]:

(i) By living with the taxpayer as a member of the household, but who otherwise has no

family relationship to the taxpayer [I.R.C. § 152(d)(2)(H)]; or

(ii) Under the rules relating to a multiple support agreement [I.R.C. § 152(d)(3)];

(2) *Test (i)*. Taxpayer household requirements.

(a) The taxpayer must occupy the household for the entire year with the individual qualifying the taxpayer for HOH status, unless the individual in question was born or died during the year. In that case, the individual must live with the taxpayer for the remaining or preceding part of the year, as applicable. Treas. Reg. § 1.2-2(c)(1).

(b) Changes in the home's location do not impact HOH status. Treas. Reg. § 1.2-2(c)(1).

(c) Temporary absences outside the home due to illness, education, business, vacation, military service, or a custody agreement under which the individual is absent for less than six months are not counted as time away from the taxpayer's household, provided that (*i*) it is reasonable to assume that the taxpayer or such other person will return to the household; and (*ii*) the taxpayer continues to maintain the household (or substantially equivalent) in anticipation of such return. Treas. Reg. § 1.2-2(c)(1).

(3) *Test (ii)*. Parent of taxpayer. I.R.C. § 2(b)(1)(B).

(a) To file with HOH status, a taxpayer need not live with a parent who qualifies as a dependent. The taxpayer must only maintain the parent's principal place of abode. Treas. Reg. § 1.2-2(c)(2).

(b) Changes in home's location do not impact HOH status. Treas. Reg. § 1.2-2(c)(2).

(c) The parent must occupy the household for the entire year. Treas. Reg. § 1.2-2(c)(2).

(d) A parent who adopted the taxpayer qualifies as the taxpayer's father or mother. Treas. Reg. § 1.2-2(b)(4). However, stepfathers or stepmothers do not qualify under the statutory language.

(e) If the taxpayer pays more than half the cost of a rest home or home for the elderly, such costs qualify as maintaining the parent's principal place of abode. *Robinson v. Comm'r*, 51 T.C. 520, 537-539 (1968); Pub. 501 (Filing Status – Head of Household Qualifying Person).

3. *Considered Unmarried*. A married taxpayer is deemed unmarried for HOH filing status in limited circumstances. I.R.C. § 7703(b). To be considered unmarried, the taxpayer must meet all of the following requirements:

a. File a separate return (i.e., S, MFS, or HOH) from the spouse. I.R.C. § 7703(b)(1).

b. Maintain as his or her home a household that constitutes for more than one-half of the year the principal place of abode of a child who qualifies as the taxpayer's dependent. I.R.C. § 7703(b)(1).

(1) "Child" includes a biological, adopted, or foster child. I.R.C. § 152(f)(1)(A)-(C).

(2) For these purposes, the rules for divorced or separated individuals in I.R.C. § 152(e) do not disqualify the child as the taxpayer's dependent. I.R.C. § 7703(b)(1).

c. Furnish more than one-half the cost of maintaining the household during the year. I.R.C. § 7703(b)(2).

(1) The taxpayer must satisfy this test to file as HOH. See above for discussion of the costs used to make this determination. Treas. Reg. §§ 1.7703-1(b)(4), 1.2-2(d).

d. During the last six months of the year, the spouse is not a member of the taxpayer's household. I.R.C. § 7703(b)(3).

(1) To be outside the household, the spouse must live in a separate residence. *Lyddan v. Comm'r*, 721 F.2d 873, 874, 876 (2d Cir. 1983); *Chiosie v. Comm'r*, T.C. Memo. 2000-117, at *6 (citing *Washington v. Comm'r*, 77 T.C. 601, 604 (1981), and concluding that Section 7703(b) requires "geographical separation" between the spouses and "living in separate residences, i.e., living under separate roofs."). The quality of the marriage or a "constructive absence" by one spouse are not relevant considerations. *Id.* (citing *Becker v. Comm'r*, T.C. Memo. 1995-177).

(2) The spouse's temporary absences due to illness, education, business, vacation, or military service do not qualify as living outside the taxpayer's household. Treas. Reg. §§ 1.7703-1(b)(5), 1.2-2(e).

F. Qualifying Widow(er) / Surviving Spouse (QW). I.R.C. § 2(a).

1. This filing status applies where a spouse died in either of the year preceding the year of death. As noted, in the year of death, a surviving spouse normally files as a married taxpayer.

2. QW status entitles an un-remarried spouse to use for two additional years the tax rates, tax brackets, standard deduction, and other benefits applicable to MFJ taxpayers. *See, e.g.*, I.R.C. §§ 1(a), 1(i), 1(j)(2)(A), 63(c)(2)(A).

3. Qualifications for qualified widow(er) status. I.R.C. § 2(a). The taxpayer must satisfy all of the following:

a. The taxpayer must not remarry before the close of the tax year. I.R.C. § 2(a)(1)(A).

b. The taxpayer must have been eligible to file with MFJ status in the year of death (even if he or she did not so file). I.R.C. § 2(a)(2)(B).

c. The taxpayer must maintain as his or her home a household that that is the principal place of abode of an individual who meets the following requirements:

(1) The individual is a biological child, stepchild, or adopted child (not a foster child) [I.R.C. § 2(a)(1)(B); Treas. Reg. § 1.2-2(a)(1)(ii)];

(2) The taxpayer could claim the child as a dependent, without regard to the following three restrictions [I.R.C. § 2(a)(1)(B)]:

(a) That the taxpayer may be claimed as a dependent by another person [I.R.C. § 152(b)(1)];

(b) That the dependent filed a joint return with a spouse [I.R.C. § 152(b)(2)]; or

(c) That the dependent earned gross income over the exemption amount [I.R.C. § 152(d)(1)(B)].

d. The dependent child qualifying the taxpayer for QW status lived with the taxpayer for the entire year, leaving aside temporary absences. Treas. Reg. § 1.2-2(a)(2), (c)(1).

(1) Temporary absences are those discussed under HOH status and include nonpermanent absences for illness, education, business, vacation, military service. Treas. Reg. § 1.2-2(c)(1).

e. The taxpayer paid more than half of the cost of maintaining the household. I.R.C. § 2(a) (flush language); Treas. Reg. § 1.2-2(a)(2), (d).

(a) The costs of maintaining the household are the same as those under HOH status, i.e., those that are "incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants." Treas. Reg. § 1.2-2(d). Expenses meeting this definition include "property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises." *Id.* Costs specifically excluded are "clothing, education, medical treatment, vacations, life insurance, and transportation," as well as the value of services rendered in the household by the taxpayer or by the dependent in question. *Id.*

VII. CONCLUSION

CHAPTER B

GROSS INCOME

TABLE OF CONTENTS

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

I. REFERENCES.

A. Internal Revenue Code (I.R.C.) §§ 61-140.

B. Treasury Regulations (Treas. Reg.).

C. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.

2. Pub. 17, Your Federal Income Tax.

3. Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.

4. Pub. 334, Tax Guide for Small Businesses.

5. Pub. 504, Divorced or Separated Individuals.

6. Pub. 525, Taxable and Nontaxable Income.

7. Pub. 527, Residential Rental Property.

8. Pub. 550, Investment Income and Expenses.

9. Pub. 575, Pension and Annuity Income.

D. IRS Forms: W-2 and 1099 series (-DIV, -G, -MISC, -NEC, -R, -S,)

II. GROSS INCOME – CONCEPTS

A. "Except as otherwise provided …, gross income means all income from whatever source derived," including compensation for services, gains from dealings in property, interest, rents, dividends, pensions, and discharge of indebtedness. I.R.C. § 61(a).

1. As the words imply, the above definition is broad. Gross income includes all "accessions to wealth." *See, e.g.*, *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (gross income includes "[a]ccessions to wealth, clearly realized, and over which the [taxpayer has] complete dominion"); *Commissioner v. Kowalski*, 434 U.S. 77, 83 (1977) (same).

2. Gross income includes payments in any form, i.e., cash, property, or services.

3. Section 61 includes numerous items not ordinarily thought of as income. These items are normally not taxable <u>not</u> because they fall outside the definition of gross income, but because the Internal Revenue Code specifically excludes them from tax. *See, e.g.*, I.R.C. §§ 102, 104, 117 (gifts, compensation for injuries, and scholarships excluded from gross income).

B. The taxpayer recognizes income after it has been "realized," i.e., the taxpayer either receives payment or consummates a sale or exchange of property. *Helvering v. Horst*, 311 U.S. 112, 115-16 (1940) ("In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued."); *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991) (a taxpayer's sale or disposal of property triggers income recognition, not its annual fluctuation in value).

1. The rule of delaying income recognition until receipt of payment or similar triggering event is founded upon "administrative convenience." *Helvering v. Horst*, 311 U.S. 112, 116 (1940)

2. Taxing income before receipt of benefits or completion of a transaction poses issues of liquidity and valuation. For example, a taxpayer may require payment before he or she has funds available to pay the tax liability arising from a transaction. Furthermore, the amount of a taxable gain or loss may not be fixed until the transaction has occurred. Taxpayers, moreover, might resist a system whereby "paper" gains (subject to reversal) are taxed. Scholars debate the necessity or desirability of the realization principle, but it is likely to remain a fixture of federal tax law in light of its longstanding institution. *See, e.g.*,

Jeffrey L. Kwall, When Should Asset Appreciation Be Taxed: The Case for a Disposition Standard of Realization, 86 Ind. L.J. 77, 80-81 (2011).

C. A taxpayer who earns income by performing services or owning property is the one who ordinarily reports it, regardless of how the proceeds are spent or the benefits directed. *Lucas v. Earl*, 281 U.S. 111 (1930); *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

1. For example, income may not be assigned to another individual, whether the income is earned for past services or for services yet to be rendered. *Helvering v. Eubank*, 311 U.S. 122, 124-25 (1940); *Helvering v. Horst*, 311 U.S. 112, 119-120 (1940).

a. The same principle applies to other forms of income. *See, e.g., Littell v. Comm'r*, 154 F.2d 922 (2d Cir. 1945) (royalties); *Schermerhorn Oil Corp. v. Comm'r*, 46 B.T.A. (1942) (oil interest)

b. A minor's income is income to him even if a parent receives it. I.R.C. § 73(a).

D. For a cash-basis, calendar-year taxpayer (most individuals), income must be reported in the year payment is received. I.R.C. § 451(a); Treas. Reg. § 1.451-1(a).

1. Therefore, prepayments are normally taxed in the year of receipt, even if the taxpayer is obligated to perform acts in a subsequent year.

2. Narrow exception for constructive receipt. The taxpayer cannot delay the reporting of income by, for example, depositing a check in the year after receiving it. If funds are under the taxpayer's control and available, he or she must report the income at such time according to the doctrine of constructive receipt. Treas. Reg. § 1.451-2(a) ("Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given."). *See also Southeastern Mail Transp., Inc. v. Comm'r*, T.C. Memo. 1987-104, 53 T.C.M. (CCH) 217, 225; *Ames v. Comm'r*, 112 T.C. 304, 311-314 (1999); *Frank v. Comm'r*, 22 T.C. 945, 952-53 (1954).

E. Income earned outside the United States. United States citizens are subject to federal taxation on their worldwide income, regardless of whether they reside within or outside the United States. Treas. Reg. § 1.1-1(b).

1. A resident alien is also generally taxed on his or her worldwide income. Treas. Reg. §§ 1.1-1(b), 1.871-1(a).

2. This rule contrasts with that of most countries, which normally tax income only if earned within the jurisdiction.

3. Because income earned in foreign jurisdictions is usually subject to foreign taxation, the Internal Revenue Code contains provisions to mitigate double-taxation of such income.

III. INCLUSION – WAGES OR COMPENSATION

A. References: I.R.C. § 61(a)(1); Treas. Reg. § 1.61-1(a); Pub. 3, Armed Forces' Tax Guide; Forms W-2 and 1099-NEC (1099-MISC before 2020).

B. A taxpayer includes all compensation for services in gross income. I.R.C. § 61(a)(1).

C. Compensation for services includes wages, salaries, fees, commissions, bonuses, termination pay, and severance pay. Treas. Reg. § 1.61-2(a)(1).

D. Government and private employers prepare a Form W-2 for each employee to report the employee's wages to the IRS and Social Security Administration. I.R.C. § 3402(a)-(b); Treas. Reg. § 31.6051-1(a).

1. Military compensation includes numerous types of pay and allowances, some of which are taxable and others that are specifically excluded by statute. Pub. 3, Table 1 lists the items included in income.

2. The Service member's Form W-2 should include the items listed in Table 1.

E. Any business that pays an independent contractor $600 or more during the year must provide the contractor and file with the IRS a Form 1099-NEC (1099-MISC before 2020) reporting the compensation paid to the individual. I.R.C. § 6041(a); Treas. Reg. § 1.6041-1(a).

1. The distinction between an independent contractor and employee is often not clear-cut, and the determination may require a fact-intensive inquiry. *See, e.g.*, *Santos v. Comm'r*, T.C. Memo. 2020-88; *Ewens & Miller, Inc. v. Comm'r*, 117 T.C. 263, 268-76 (2001); *Weber v. Comm'r*, 103 T.C. 378 (1994), *aff'd per curiam*, 60 F.3d 1104 (4th Cir. 1995).

2. In general, a business controls both the means by which an employee performs his or her work and the end result of that work. By contrast, a business controls only the end result of an independent contractor's efforts. Treas. Reg. § 31.3121(d)-1(c)(2) (An employer-employee relationship is one where the employer has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done.").

3. Note. An independent contractor pays self-employment tax in lieu of Social Security, Medicare, and other payroll taxes. The Form 1099 reporting regime assists the IRS in ensuring that the independent contractor pays those taxes. Such income is reported on Schedule C to ensure the proper payment of self-employment tax. See Form 1040, Schedules C and SE.

IV. INCLUSION – INTEREST, DIVIDENDS, AND CAPITAL GAINS

A. Interest.

1. References: I.R.C. § 61(a)(4); Treas. Reg. § 1.61-7(a)-(b); Pub. 550, Investment Income and Expenses; Forms 1099-INT, 1099-OID, and 1040, Schedule B, Part I.

2. Interest received or credited to taxpayer's account is included in gross income unless it is specifically exempt from tax. I.R.C. § 61(a)(4); Treas. Reg. § 1.61-7(a)-(b).

3. Interest paid on United States obligations, such as Treasury bills, notes, and bonds, is taxable.

   a. Such interest is exempt from state and local tax.

   b. U.S. Savings Bonds. Interest is normally deferred until the earlier of the bond's disposal date or maturity date.

(1) The taxpayer may elect to report interest income over the life of the bond. I.R.C. § 454(a); Treas. Reg. § 1.454-1(a).

(2) If the taxpayer makes the election, the amount reported each year is the increase in redemption price each year. *Id.*

(a) If the election takes place after the first year, the taxpayer must report interest for prior years in the first year of election. *Id.*

(3) Most taxpayers elect to report interest income at maturity. Series EE/E Savings Bonds Tax Considerations, https://www.treasurydirect.gov/indiv/research/indepth/ebonds/res_e_bonds_eetaxconsider.htm; Tax Considerations for I Bonds, https://www.treasurydirect.gov/indiv/research/indepth/ibonds/res_ibonds_itaxconsider.htm. The taxpayer should make the decision based on his or her expected future tax rate and the anticipated value in delaying the reporting of interest income.

4. A taxpayer may receive and may be obligated to report interest income not directly paid in cash or credited to an account.

a. Short-term U.S. Treasury and state or local obligations. Interest on these obligations, where they (*i*) mature in less than one year, (*ii*) pay no interest, (*iii*) are issued at a discount, and (*iv*) are redeemed at a specified amount, is deemed accrued on the date of sale, disposal, or maturity, as appropriate. I.R.C. § 454(b). In other words, the taxpayer reports the interest income in the year of sale, disposal, or redemption.

b. Original Issue Discount (OID). Debt instruments issued at a discount that do not pay periodic interest generally have OID. The difference between the issue price and stated redemption price represents interest. For example, a $10,000 bond issued for $9,000 has $1,000 of OID, which is interest taxable over the life of the bond based on standard methods of interest computation.

(1) OID rules normally do not apply if the term of the debt instrument is one year or less.

(2) OID is *de minimis* and non-taxable where the discount is less than one-fourth of one percent (0.0025) of the redemption price

multiplied by the number of years to maturity. For example, a ten-year, $10,000 bond issued at $9,800 has de minimis OID: $10,000 – $9,800 = $200, which is less than $10,000 × 0.0025 × 10 = $250.

c. Bonds sold between interest payment dates. Bonds normally pay interest on specified dates each calendar year, e.g., February 1 and August 1. A buyer who purchases a bond between such dates pays an extra amount representing the interest that the buyer will receive on the next interest-payment date relating to the period of the seller's ownership.

(1) For example, using interest-payment dates of February 1 and August 1, a buyer purchasing the bond on April 1 will pay an extra amount representing interest owed to the seller from February 1 to April 1, since the buyer will receive the full amount of the scheduled interest payment on August 1. The extra amount paid by the buyer represents interest income to the seller, which the seller reports in the year of sale.

(2) The buyer includes the extra amount paid in his or her cost basis for the bond. (See Chapter H, Tax Aspects of Stocks and Mutual Funds). The buyer reduces this cost basis after receiving payment for the accrued interest.

5. Tax-exempt interest must be reported on Form 1040, even though not taxed. I.R.C. § 6012(d); Form 1040.

6. Financial institutions are required to report to the taxpayer and the IRS on Form 1099-INT payments of interest aggregating more than $10 during the year. I.R.C. § 6049(a), (d); Treas. Reg. §§ 1.6049-4 *et seq.* These payors issue Form 1099-OID to report payments of more than $10 in OID interest.

a. Forms 1099-INT or 1099-OID received by the taxpayer should already incorporate the considerations discussed above, namely, discounts from the redemption price, accrued interest, and tax-exempt interest.

(1) See Pub. 550 for circumstances where the taxpayer may need to adjust the amount reported on a Form 1099-INT or 1099-OID.

b. Note: a payor's failure to submit a Form 1099-INT or other document to a taxpayer (or lack of a requirement to do so) does not relieve the taxpayer of the obligation to report the income.

7. If a taxpayer's interest income exceeds $1,500 or in other specified circumstances, Form 1040 requires the taxpayer to separately list the payors and amounts on Form 1040, Schedule B, Part I.

B. Capital gains and losses.

1. References: I.R.C. §§ 1(h)(11), 61(a)(3), 1001, 1012, 1221-1222; Treas. Reg. § 1.61-6; Pub. 544, Sales and Dispositions of Assets; Forms 1040, Schedule D, and 8949. See also Chapters H and J for more detailed discussions of investments and property sales.

2. A taxpayer must include in gross income all "gains from dealings in property." I.R.C. § 61(a)(3). For example, if a taxpayer realizes a profit from selling a piece of artwork, he or she must report the gain and pay tax on it.

3. The gain from a sale or disposition of property is the "amount realized" for the property less the property's "adjusted basis."

a. The amount realized is the sum of the cash and the fair market value of other property received in return for the property. I.R.C. § 1001(b).

b. The adjusted basis is the cost of the property, including allowable adjustments for items such as depreciation. I.R.C. § 1012(a)(2).

4. Most of a taxpayer's assets are "capital assets."

a. A capital asset generally includes all assets held by a taxpayer for personal or investment use. This includes the taxpayer's residence, vehicles, personal possessions, stocks, bonds, and artwork. The definition is broad and exceptions are specifically stated. Exceptions include inventory, accounts receivable, and property held for sale to customers in the taxpayer's ordinary course of business, as well as depreciable property used in a trade or business. I.R.C. § 1221(a).

b. The Internal Revenue Code distinguishes short-term and long-term gains. Short-term gains result from sales or dispositions of property held for one year or less; long-term property is held for more than one year. I.R.C. § 1222(1)-(4).

c. If net long-term capital gains arise following a netting procedure for capital gains and losses set forth in the Internal Revenue Code, they are taxed at lower rates, specifically, 0%, 15%, or 20%. The Code refers to such favorably taxed gains as "net capital gain," namely, "the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year." I.R.C. § 1222(11).

d. The most important asset for many taxpayers is a personal residence. Under certain circumstances, the Code allows a taxpayer to entirely exclude any gain from the sale of a personal residence lived in for two of the five previous years (see below and Chapter J).

e. Schedule D of Form 1040 and Form 8949 implement the netting process mandated by the Internal Revenue Code for determining net capital gain.

(1) An overview of the netting process follows:

(a) Short-term capital gains and short-term capital losses are netted;

(b) Long term-capital gains and long-term capital losses are netted;

(c) If the results of the first two steps yield numbers of opposite signs (i.e., an overall gain for short-term items and a loss for long-term items, or vice versa), the long-term and short-term results are netted once more.

(d) If the results of the first two steps yield both a short-term and a long-term gain or both a short-term and a long-term loss, the short- or long-term character of these gains or losses is retained, and no further netting takes place.

(2) Consequences of netting:

(a) Any short-term capital gain, whether as the overall consequence of step (3) or because no further netting was allowed after steps (1) and (2), is taxed as ordinary income at the taxpayer's applicable rate (there is no tax benefit).

(b) Short-term and long-term capital losses retain their independent character and may be deducted against the taxpayer's other income for a maximum of $3,000 per year, with any excess carried forward indefinitely. (See Chapter H for details.)

(c) If long-term capital gain exceeds short-term capital loss, the result is "net capital gain," which, as discussed above, is taxed at favorable capital gains rates.

f. An additional 3.8% surtax (net investment income tax) is imposed on the net investment income of taxpayers with modified AGI exceeding specified amounts (specifically, $200,000 for Single and HOH, $250,000 for MFJ and QW, and $125,000 for MFS). Treas. Reg. § 1.1411-2; *see generally* Treas. Reg. §§ 1.1411-1 – 1.1411-10; Form 8960.

g. After the netting procedure takes place on Form 8949 and Schedule D, the result is carried forward to Form 1040.

h. Third-parties may report sales of capital assets to the taxpayer on Forms 1099-B (broker and barter transactions), 1099-DIV (capital gain distributions from a mutual fund), or 1099-S (real estate). Capital gains from stocks or mutual funds are covered in Chapter H, and real estate transactions are covered in Chapters J and K.

C. Dividends.

1. References: I.R.C. § 61(a)(7); Treas. Reg. § 1.61-9; Pub. 550, Investment Income and Expenses; Forms 1099-DIV and 1040, Schedule B, Part II.

2. Dividends are taxable distributions to a shareholder with respect to his or her ownership of stock in a corporation. I.R.C. §§ 301(c)(1), 316(a).

a. Taxpayers often receive dividends through mutual funds or other investment vehicles. The mutual fund passes through to investors the dividends, capital gains, or other income received from the fund's investments.

b. Note. Not all corporate distributions are taxable; see Chapter H for more details.

3. Ordinary dividends are paid out of a company's "earnings and profits" (E&P). E&P is a measure of a company's ability to pay dividends and is recorded within the accounting and tax records of a corporation. A corporation's positive taxable income, for example, increases its E&P; taxes and dividends paid by the corporation, on the other hand, decrease E&P. The computation of E&P is complicated and reliant upon records generally not available to shareholders. Therefore, the shareholder normally must rely upon the paying corporation to state whether a distribution was made from E&P and constitutes a taxable dividend. Absent any statement to the contrary, the taxpayer should assume that amy dividend reported on Form 1099-DIV is an ordinary dividend and taxable as such.

a. Qualified dividends.

(1) These constitute a subset of ordinary dividends. Qualified dividends are taxable at favorable tax rates, specifically, the tax rates that apply to net capital gain, i.e., 0%, 15%, or 20%.

(2) Qualified dividends include those paid by domestic corporations and qualified foreign corporations. The latter include corporations incorporated in a United States possession and foreign corporations paying dividends on shares publicly traded on a securities market in the United States (such as the New York Stock Exchange or NASDAQ). I.R.C. § 1(h)(11)(C)(i)(I), (ii).

4. Certain credit unions, mutual savings banks, and similar institutions pay "dividends" that in fact represent interest income. Payors of such interest should report it on Form 1099-INT, and the taxpayer should report any such amount as taxable interest income. However, dividends from money market funds represent taxable dividend income that the taxpayer should report as such.

5. Dividends from insurance companies to their policy holders are not dividends and generally not taxable (they represent an offset to premiums). However, interest paid on policy holder premiums is taxable as interest income.

6. Payors of dividends must report them to the taxpayer and the IRS on Form 1099-DIV. I.R.C. § 6042(a); Treas. Reg. § 1.6042-2(a).

   a. Form 1099-DIV indicates whether the dividends are qualified. If the dividends result from shares held for a short period of time (60 days or less) or the taxpayer is under any agreement to make payments with respect to positions in similar property (such as a short sale agreement), see Chapter H to determine whether the dividends are in fact qualified, regardless of how the Form 1099-DIV characterizes the amount.

   b. The taxpayer should assume that dividends are taxable distributions unless the payor (generally the corporation or the mutual fund) states otherwise.

   c. Note. A payor's failure to submit Form 1099-INT to a taxpayer (or lack of a requirement to do so) does not relieve the taxpayer of his or her obligation to report the income.

7. If over $1,500 or in other specified circumstances, the taxpayer must list each payor on Form 1040, Schedule B, Part II.

V. INCLUSION – STATE AND LOCAL INCOME TAX REFUNDS

A. References: I.R.C. §§ 111, 6050E; Treas. Reg. §§ 1.111-1, 1.6050E-1; Forms 1099-G and 1040, Schedule 1.

B. State and local income tax refunds are taxable in certain circumstances. The refunds are taxable depending on whether the taxpayer previously claimed a deduction and received a tax benefit for payment of state or local tax. (As noted in Chapter D, taxpayers who itemize deductions may claim a deduction for state and local income tax paid.)

C. Tax Benefit Rule. The taxpayer must include in income any amount that represents the recovery of a prior deduction. I.R.C. § 111.

1. Under this rule, the taxpayer may need to report a state or local tax refund as taxable income.

2. Example. Suppose a taxpayer paid $5,000 in state income tax during the course of 20X1 through payroll deductions. The taxpayer files federal and state tax returns in April 20X2 and claims a deduction for $5,000 in state income tax on his 20X1 federal return. Assume the taxpayer is eligible to deduct the full amount. In May 20X2, however, the taxpayer receives a refund of $500 from the state revenue authority because the income tax liability was only $4,500. The $500 represents income in 20X2 because it represents a recovery of an amount for which the taxpayer previously received a tax benefit. Ideally, the taxpayer should have deducted only $4,500 on his or her 20X1 return; however, instead of requiring an amended return for 20X1, the Internal Revenue Code has the taxpayer "make up" for the overstated deduction by reporting additional income when the benefit is later received.

D. Confusingly, the Internal Revenue Code characterizes the tax benefit rule as a gross income exclusion. I.R.C. § 111(a). Specifically, the Code provides that "[g]ross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter." This language, though awkward, emphasizes the default position discussed above with respect to any financial benefit received by a taxpayer; the taxpayer should assume the amount is included in gross income, unless another provision states otherwise.

1. By its terms, the tax benefit rule applies broadly to many types of deductions. For most individual taxpayers, however, the issue arises only with respect to state and local income tax.

2. The Form 1040 Instructions contain a worksheet to determine the taxable portion of a state or local tax refund. The complications of the worksheet result primarily in determining the amount of the prior benefit received by the taxpayer. The benefit depends on a number of considerations, such as whether the $10,000 limitation for tax years 2018 through 2025 limited the taxpayer's deduction (see Chapter D) and whether the taxpayer was subject to Alternative Minimum Tax (AMT) (as discussed in Chapter F, state and local taxes are not deductible for AMT purposes).

3. To determine whether a refund in the current year will be taxable, the following approach may be used:

a. Determine whether the taxpayer (*i*) claimed the standard deduction or itemized deductions the previous year; and (*ii*) if the latter, whether he or she claimed any deduction for state and local tax. If the taxpayer either claimed the standard deduction or claimed no itemized deduction for state

and local income tax, the tax refund is non-taxable. In either circumstance, the taxpayer received no benefit from the deduction.

b. If taxpayer itemized deductions and claimed an amount for state and local income tax, the worksheet computation is required (and, in practice, will be performed by computer software).

E. State and local government officials must issue the taxpayer a Form 1099-G to report refunds of state and local income. I.R.C. § 6050E; Treas. Reg. § 1.6050E-1.

F. The taxpayer reports the taxable amount on Form 1040, Schedule 1, Part I.

VI. INCLUSION – ALIMONY AND SEPARATE MAINTENANCE

A. References: I.R.C. §§ 62(a)(10), 71, and 215 (before repeal by Pub. L. No. 115-97 (Dec. 22, 2017) (hereafter, "Former Section 62(a)(10)," "Former Section 215," and "Former Section 71"); Treas. Reg. §§ 1.61-10, 1.71-1; Temp. Treas. Reg. § 1.71-1T; Pub. 504, Divorced or Separated Individuals.

1. Alimony and separate maintenance is referred to collectively as "alimony" below.

B. Decrees after 31 December 2018.

1. There are no tax consequences to either spouse for payment of alimony. The recipient spouse reports no income, and the payor spouse is entitled to no deduction. This mirrors the treatment of child support payments. Former Section 71(c)(1); Temp. Treas. Reg. § 1.71-1T(c), Q&A 15; *Proctor v. Comm'r*, 129 T.C. 92, 94-95 (2007) (child support non-deductible by payor); *Engelhardt v. Comm'r*, 58 T.C. 641, 649-60 (1972) (child support not includable in income of recipient).

C. Decrees before 1 January 2019.

1. The tax treatment of alimony for pre-2019 decrees differs from child support and property settlements, the latter of which are, like child support, are non-taxable to the recipient and non-deductible to the payor. I.R.C. § 1041(b); *Goldman v. Comm'r*, 112 T.C. 317, 322 (1999) ("Generally, property settlements (or transfers of property between spouses) incident to a divorce neither are taxable events nor give rise to deductions or recognizable income."). The Internal Revenue Code

combats disguised property settlements via front-loaded alimony payments by requiring the payor spouse to report income when the payments are excessively front-loaded. Former Section 71(f); Temp. Treas. Reg. § 1.71-1T(d), Q&A 19-25; Pub. 504 (Alimony – Recapture of Alimony). See Pub. 504, Worksheet 1 for the calculation.

2. A taxpayer receiving alimony for a pre-2019 decree must include the payments in gross income. Former Section 71(a); Treas. Reg. §§ 1.61-10, 1.71-1(b); Temp. Treas. Reg. § 1.71-1T(a), Q&A 1.

3. The recipient reports alimony received on Form 1040, Schedule 1, Part I.

D. See Chapter C for a more detailed discussion of the types of payments that qualify as alimony and entitle the payor to a deduction.

VII. INCLUSION – PENSIONS AND ANNUITIES

A. References: I.R.C. §§ 61(a)(8) & (a)(10), 72; Treas. Reg. §§ 1.61-11(a), 1.72-1(a); Pub. 575, Pension and Annuity Income; Forms 1040 and 1099-R.

B. A taxpayer generally must include pension and annuity payments in gross income. I.R.C. § 61(a)(10); Treas. Reg. § 1.61-11(a); *Harrell v. Comm'r*, T.C. Memo 2017-76, at *6-7.

1. The taxable portion of a pension payment is the portion as to which the taxpayer either did not make a contribution or contributed on a tax-deferred basis. For example, both employer and tax-deferred employee contributions to an employer-sponsored pension plan will result in fully taxable retirement distributions.

a. To exclude any pension payments from income, in other words, the taxpayer must have contributed previously taxed funds to the plan.

2. If the taxpayer contributed to the plan on an after-tax basis, the taxable portion is calculated by determining both (1) the expected return under the plan and (2) the taxpayer's investment in the plan. I.R.C. § 72(b)(1), (c)(1); Treas. Reg. §§ 1.72-5, 1.72-6.

a. The expected return is based upon the amount of annual payments to the taxpayer and the time period over which the payments will be made. This amount is either the:

(1) Aggregate amount to be received, if the amount is not based on the life expectancy of an individual [I.R.C. § 72(c)(3)(A)]; or

(2) If based on life expectancy, the amount determined by tables set forth by the IRS [I.R.C. § 72(c)(3)(B); Treas. Reg. § 1.72-9].

b. The "investment in the contract" is generally the aggregate amount of premiums or other consideration contributed by the taxpayer. I.R.C. § 72(c)(1)(A); Treas. Reg. § 1.72-6(a)(1). This amount represents reduction or return of premiums paid. I.R.C. § 72(b)(1)-(2); Treas. Reg. § 1.72-1(b), (d). *See also Harrell*, T.C. Memo. 2017-76, at *7-8.

c. The excludable portion of a pension or annuity payment is the *pro rata* portion of the payment relating to the taxpayer's investment in the contract. I.R.C. § 72(b)(1); Treas. Reg. § 1.72-4(a). This "exclusion ratio" is the following fraction determined as of the annuity start date. *Id.*; I.R.C. § 72(c)(4) (specifying annuity start date); Treas. Reg. § 1.72-4(a); *Harrell*, at *9-11.

C. Gross income includes military pensions determined by rank and length of service. I.R.C. § 61(a)(10); Treas. Reg. § 1.61-11(a). *See also Schuller v. Comm'r*, T.C. Memo. 2012-347, at *6-7.

1. Note many states, however, exclude military retirement pay from taxation.

2. See below for exclusions from gross income for Veterans Administration disability payments.

VIII. INCLUSION – UNEMPLOYMENT COMPENSATION

A. References: I.R.C. § 85; Forms 1040, Schedule 1 and 1099-G.

1. Gross income includes unemployment compensation received under any state or federal law in the year of receipt. I.R.C. § 85; *Yoklic v. Comm'r*, T.C. Memo. 2017-143; *Timmins v. Comm'r*, T.C. Memo. 2017-86.

2. Any payor of unemployment compensation aggregating $10 or more to an individual must file Form 1099-G with the IRS and issue a copy to the individual. I.R.C. § 6050B.

3. Report unemployment compensation on Form 1040, Schedule 1, Part I.

IX. INCLUSION – SOCIAL SECURITY BENEFITS

A. References: I.R.C. § 86; Pub. 915, Social Security and Equivalent Railroad Retirement Benefits; Forms 1040 and SSA-1099.

B. The portion of a taxpayer's Social Security benefits includible in gross income is established under complex statutory formula. I.R.C. § 86(a)-(d). The discussion below addresses the statutory mechanics in detail; in practice, computer software performs the computation. Elsewhere in this Deskbook, the reader is referred to the IRS forms or publications where detailed worksheets are available (e.g., in the discussion above for taxable state and local income tax refunds). The taxation of Social Security benefits is addressed in greater detail based on the confusion this topic creates and the number of taxpayers who receive these benefits. The computation, moreover, is less dependent on the taxpayer's individual circumstances than is the case for taxable state and local income tax refunds (discussed previously) and other items. Accordingly, this topic illustrates the operation of the Internal Revenue Code in practice.

C. The statutory formula for computing taxable Social Security benefits applies to payments under Title II of the Social Security Act, 42 U.S.C. §§ 401-34, which encompasses retirement, survivor, and disability benefits. I.R.C. § 86(d)(1)(A). Each year, a taxpayer receiving such benefits receives a Form SSA-1099 reporting the benefits paid and other information.

1. The formula for taxation of Title II benefits also applies to comparable Railroad Retirement benefits. These comparable benefits comprise the Social Security Equivalent Benefit (SSEB) portion of tier 1 Railroad Retirement benefits. A taxpayer receiving such benefits receives a Form RRA-1099 instead of Form SSA-1099.

2. Supplemental Security Income (SSI) payments, which are based on disability or financial need, are not taxable and not included in the formula described below.

    a. However, SSI benefits should not be confused with Social Security Disability Insurance (SSDI) benefits. SSDI is paid under Title II, and benefits are based on work history and prior contributions. *Palsgaard v. Comm'r*, T.C. Memo. 2018-82, at *3, *5-6.

b. Where workers' compensation benefits reduce SSDI payments under Section 224 of the Social Security Act, 42 U.S.C. § 424a, the taxpayer must include such workers' compensation payments in income. I.R.C. § 86(d); *Moore v. Comm'r*, T.C. Memo. 2012-249, at *4-5.

D. Definitions for the Statutory Formula.

1. Modified Adjusted Gross Income (MAGI). This equals Adjusted Gross Income (AGI), determined without regard to the following:

a. Social Security benefits [I.R.C. § 86];

b. U.S. Savings Bond interest used for education expenses [I.R.C. § 135];

c. Employer-paid qualified adoption expenses [I.R.C. § 137];

d. Student loan interest deduction [I.R.C. § 221];

e. Tuition and fees deduction [I.R.C. § 222];

f. Foreign earned income exclusion [I.R.C. § 911];

g. Excluded Income: Guam, American Samoa, or Northern Marianas [I.R.C. § 931];

h. Excluded Income: Puerto Rico [I.R.C. § 933]; and

i. Tax-exempt interest [I.R.C. § 103(a)].

Note. MAGI is used throughout the Internal Revenue Code and defined differently depending on the tax provision in question. Broadly speaking, and as shown above, MAGI normally adds back the tax item itself (here, Social Security benefits) and exclusions for income earned outside the territorial United States. In addition, MAGI frequently requires add-back of educational benefits in the form of gross income exclusions or above-the-line deductions, such as the interest exclusion for U.S. Savings bonds (discussed below) and the deductions for student loan interest and tuition and fees (see Chapter C).

2. Provisional income (PI). This term does not appear in the statute, but is mentioned in the legislative history and equals MAGI + one-half of Social Security benefits (SSB) received, i.e., PI = {MAGI + 50% × SSB}. I.R.C. § 86(b)(1); H. Rep. No. 103-111, 103d Cong., 1st Sess. 654 (1993), 1993-3 C.B. 167, 230 (discussing provisional income).

3. Base amount (BA). Note this amount is not adjusted for inflation.

   a. $25,000 for all filers except those stated below. I.R.C. § 86(c)(1)(A).

   b. $32,000 for a joint return. I.R.C. § 86(c)(1)(B).

   c. $0 if the taxpayer is married, does not file a joint return, and lived with his or her spouse at any time during the year. I.R.C. § 86(c)(1)(C).

4. Adjusted base amount (ABA). Note this amount is not adjusted for inflation.

   a. $34,000 for all filers except those stated below. I.R.C. § 86(c)(1)(A).

   b. $44,000 for a joint return. I.R.C. § 86(c)(1)(B).

   c. $0 if the taxpayer is married, does not file a joint return, and lived with his or her spouse at any time during the year. I.R.C. § 86(c)(1)(C).

E. The statutory formula reduces to three cases [I.R.C. § 86(a)(1)-(2), (b)(1)]:

1. Case 1: Provisional income is less than or equal to the base amount. If PI ≤ BA, the taxpayer excludes all Social Security benefits (SSB) from income.

2. Case 2: Provisional income exceeds the base amount but not the adjusted base amount. If PI > BA and ≤ ABA, the taxpayer includes in gross income the lesser of the following:

   a. 50 percent of the taxpayer's Social Security benefits, 50% × SSB, or

   b. 50 percent of PI less the BA, i.e., 50% × {PI – BA}.

3. Case 3: Provisional income exceeds the ABA. If PI > ABA, then the taxpayer includes in gross income the lesser of the following:

a. 85 percent of the taxpayer's Social Security benefits, i.e., 85% × SSB, or

b. 85 percent of PI less the ABA [85% × {PI – ABA}], plus the lesser of:

(1) 50 percent of the ABA less the BA, i.e., 50% × {ABA – BA} (in most cases, this is 50% × {$34,000 – $25,000} = $4,500 or 50% × $44,000 – $32,000 = $6,000, the latter for MFJ), or

(2) The amount included in income under Case 2, i.e., 50% × SSB or 50% × {PI – BA}, whichever amount is lesser.

F. The Social Security Administration may pay benefits in one year that relate to prior year, e.g., when an award of benefits is retroactive. As noted above, a cash-basis taxpayer (which includes almost everyone) must report income in the year of receipt, regardless of the year to which the benefits are attributable. The formula above may subject a larger portion of benefits to tax than would have been the case if the taxpayer had received the benefits in the years to which they relate. Because of this, the taxpayer may elect under I.R.C. § 86(e) to limit the taxable portion of a lump-sum payment to the sum of the amounts that would have been included in prior years if they had been received at such times.

G. Deductions and Repayments. I.R.C. § 86(d)(2), 1341. A taxpayer may be required to repay benefits received in a prior year. Form 1099-SSA will specify the amount repaid in the current year as an offset to other amounts received that year. If the result is negative, the tax treatment is as follows:

1. Deduction. If the negative amount is $3,000 or less, the amount is a miscellaneous itemized deduction.

a. Therefore, for tax years 2018 through 2025, no deduction is allowed. I.R.C. § 217(g).

b. For other years, the amount is a miscellaneous itemized deduction subject to the 2% AGI floor. I.R.C. § 217(a).

2. Repayment. If the amount exceeds $3,000, the taxpayer's tax liability is the lesser of :

a. The tax owed if the amount were allowed as a deduction in the current year [I.R.C. § 1341(a)(3)-(4)]; or

b. The decrease in tax that would result in prior years from exclusion of the income [I.R.C. § 1341(a)(3), (a)(5)].

X. OTHER GROSS INCOME INCLUSIONS

A. Business Income.

1. References: I.R.C. § 61(a)(2); Pub. 334, Tax Guide for Small Business; Forms 1099-NEC (-MISC before 2020) and 1040, Schedule C.

2. A proprietor reports income and deductions from a trade or business on Schedule C.

3. Schedule C shows that for a business that manufactures products or sells goods (or is engaged in mining activities), gross receipts are reduced by the cost of inventory to arrive at "gross income." Specifically, gross income for such a business means total sales, less cost of goods sold, plus any income from incidental or outside sources (such as investments or outside operations). Treas. Reg. § 1.61-3(a). Cost of goods sold is the only deduction in federal tax law that is allowed in determining gross income.

4. Normally, an entity that has a single owner and does not elect corporation status will report its income and deductions on Schedule C because the entity will be disregarded as separate from its owner. Treas. Reg. § 301.7701-3(b)(1).

5. Military tax assistance generally does not include preparation of tax returns reporting income and deductions from substantial private business activities. AR 27-3, para. 3–5*h*(3). Substantial business activities are those that do not qualify for the IRS's VITA program for preparation of Schedule C (or Schedule C-EZ before 2019). Schedules C outside the program include those with inventory, employees, contract labor, depreciation, business use of the home, or expenses over $25,000. See Pub. 4012, VITA/TCE Volunteer Resource Guide (Tab D: Income – Schedule C Menu). However, family childcare providers are

an exception to this general rule. AR 27-3, para. 3–8*a*(3). See also Chapter X, Appendix.

B. Individual Retirement Arrangement (IRA) Distributions.

1. References: I.R.C. §§ 72, 408(d), 408A(d); Pub. 590-B, Distributions from Individual Retirement Arrangements.

2. Traditional IRA distributions are presumptively included in gross income.

a. A portion of a Traditional IRA distribution may represent non-taxable return of basis ("investment in the contract"). I.R.C. §§ 408(d)(2)(C), 72(c)(1).

b. Gross income does not include "qualified distributions" from a Roth IRA. I.R.C. § 408A(d)(1).

3. IRA distributions are discussed in more detail at Chapter I, Tax Aspects of IRAs.

4. The trustee for the IRA files with the IRS and provides to the taxpayer Form 1099-R, which specifies the gross and taxable amounts of the distribution and provides other information.

5. The taxpayer reports the gross and taxable amount of IRA distributions on Form 1040.

C. Rents and Royalties.

1. References: I.R.C. § 61(a)(5)-(6); Treas. Reg § 1.61-8; Pub. 527, Residential Rental Property; Forms 1040 (Schedules 1 and E) and 1099-MISC.

2. Gross income includes rents and royalties received during the year. I.R.C. § 61(a)(5); Treas. Reg. § 1.61-8.

a. Rents and royalties are not reduced by expenses in determining gross income from these activities. In other words, if a taxpayer has no other income, sufficient gross rents or royalties will trigger a requirement to file a tax return for the year.

b. In determining adjusted gross income and taxable income, however, the landlord or property owner may deduct his or her expenses to produce rental or royalty income, such as depreciation, mortgage interest, taxes, and other expenses. I.R.C. §§ 62(a)(5), 212(1)-(2).

c. For military members, rental income arises most commonly from rentals of residential real property, which is discussed in detail in Chapter J.

d. Note a taxpayer must include prepayments of rent in gross income, even if they relate to a future year. Treas. Reg. § 1.61-8(b). The taxpayer treats lease cancellation payments in the same manner (they represent a substitute for rent). *Id.*

3. Rental income and deductions are reported on Form 1040, Schedule E. The net amount is carried forward to Form 1040, Schedule 1, Part I.

4. If the taxpayer receives rents or royalties from a third party, such as a management company, the taxpayer should receive a Form 1099-MISC showing the rents received during the year.

D. Prizes and Awards.

1. References: I.R.C. § 74; Treas. Reg. § 1.74-1; Pub. 525, Taxable and Nontaxable Income.

2. Gross income includes prizes and awards from contests and similar sources, unless the item falls within one of three exceptions. I.R.C. § 74(a). If not paid in cash, the recipient must include in income the fair market value of any goods or services received. Treas. Reg. § 1.74-1(a)(2).

3. Exceptions.

a. Transfers to government unit or charity. If (*i*) the award or prize was made in recognition of the taxpayer's achievement in religious, charitable, scientific, educational, artistic, literary, or civic fields; (*ii*) the taxpayer was selected without any action on his or her part; (*iii*) the taxpayer is not required to render substantial future services; and (*iv*) the payor transfers the prize or award to a governmental unit or charity designated by the taxpayer and described in I.R.C. § 170(c)(1)-(2), the taxpayer may exclude the prize or award from gross income. I.R.C. § 170(b); Treas. Reg.

§ 1.71-1(b); Rev. Proc. 87-54, 1987-41 I.R.B. 37 (establishing safe harbor procedures).

b. Employee achievement awards of tangible personal property. The taxpayer may exclude from income an employee achievement award of tangible personal property (no cash, cash equivalents, or gift cards, unless under an arrangement whereby the employee may choose from an array of pre-approved items) in the following circumstances:

(1) The award meets the definition of an employee achievement award in I.R.C. § 274(j), namely, it is awarded for the employee's length of service or safety achievement as part of meaningful presentation and under circumstances that do not indicate a significant likelihood of disguised compensation. I.R.C. §§ 74(c)(1), 274(j)(3)(A).

(a) Length of service awards, for example, may not be awarded during an employee's first five years of employment, nor more than every five years. I.R.C. § 274(j)(4)(B). Safety awards may not be awarded to more than 10 percent of employees, nor to managers, clerical workers, or other professional employees. I.R.C. § 274(j)(4)(C).

(2) The value does not exceed $1,600 under a qualified plan or $400 under a non-qualified plan. I.R.C. § 274(j)(2).

(a) A qualified plan is generally one that does not discriminate in favor of highly compensated employees. I.R.C. § 274(j)(3)(B)(i).

(3) The cost to the employer does not exceed the amount allowable as a deduction (see previous requirement). I.R.C. § 74(c)(1).

c. Olympic and Paralympic games. Unless the taxpayer's AGI exceeds $1 million (without regard to Section 74), gross income excludes the value of any medal or any prize money received from the United States Olympic Committee from competition in the Olympic or Paralympic Games. I.R.C. § 74(d)(1), (d)(2)(A).

(1) Unless the $1 million exception applies, the prize or award will not increase AGI for purposes of benefits such as the exclusion of interest used for qualified education expenses (see below) or the IRA deduction. I.R.C. § 74(d)(2)(B) ("For purposes of sections 86, 135, 137, 219, 221, 222, and 469, adjusted gross income shall be determined after the application of [the income exclusion] and before the application of [the $1 million exception].").

d. Qualified scholarships are not taxable as awards or prizes and are excluded from gross income, as discussed below. I.R.C. §§ 74(a), 117.

E. Farm income. Treas. Reg. § 1.61-4; Pub. 225, Farmer's Tax Guide.

F. Gambling.

1. Gross income includes gains from gambling, betting, and lotteries. I.R.C. § 61(a); Rev. Rul. 83-130, 1983-2 C.B. 148 (citing *Dunnock v. Comm'r*, 41 T.C.M. (CCH) 146 (Oct. 1, 1980)).

a. A deduction of wagering losses is allowed only to the extent of the taxpayer's gains from similar transactions. I.R.C. § 165(d); Treas. Reg. § 1.165-10.

b. Losses are "nonbusiness losses" and deductible only if itemized on Schedule A, Form 1040.

G. Discharge of indebtedness.

1. Discharge of indebtedness is generally included in gross income. I.R.C. § 61(a)(12)).

2. Unless:

a. Discharged in Bankruptcy (11 U.S.C. § 32), or

b. Discharge results from an agreement among creditors if immediately thereafter the taxpayer's liabilities exceed value of assets. Treas. Reg. § 1.61-12(b).

3. A taxpayer should receive a 1099-C indicating the amount of income from discharge of indebtedness. The income will be reported as "other income" on Form 1040.

4. Tax extender provision. Congress periodically renews a provision allowing taxpayers to exclude from gross income the discharge of indebtedness arising from sale of a principal residence. I.R.C. § 108(a)(1)(E), (h). The income discharged reduces the basis of the taxpayer's principal residence. I.R.C. § 108(h)(1). Consult Pub. 525 (Miscellaneous Income – Cancelled Debts) and Form 982 for more information.

XI. EXCLUSION – MILITARY BENEFITS

A. References: I.R.C. §§ 112, 134; Treas. Reg. § 1.62-2(b); Pub. 3, Armed Forces' Tax Guide.

B. Gross income does not include "qualified military benefits." I.R.C. § 134(a).

1. These include any allowance or in-kind benefit, other than use of a personal vehicle, received by military member or his dependent, and which "was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date" (other than the Internal Revenue Code). I.R.C. § 134(b)(1).

a. The House conference report for the Tax Reform Act of 1986 contains a detailed list of benefits intended to be exhaustive. H.R. Rep. No. 99-841, vol. 2, at 548-49 (1986) (Conf. Rep.).

b. Pub. 3, Table 2 also contains a list of items excludable from a military member's pay under I.R.C. § 134 and other provisions. Exclusions include the Basic Allowance for Housing (BAH), the Basic Allowance for Subsistence (BAS), the Overseas Housing Allowance (OHA), moving and dislocation allowances, most Military base realignment and closure benefits (i.e., the Homeowners Assistance Program), educational allowances, and uniform allowances.

c. Practice note. In the normal course, the military member's Form W-2 should already account for these exclusions. In the event of an error, the member should seek a corrected Form W-2; he or she should not file a tax

return reporting wages in an amount different than that stated on the Form W-2.

C. Combat zone tax exclusion. Pursuant to I.R.C. § 112, gross income does not include compensation earned in any month during which a military member (*i*) served in a combat zone or (*ii*) is hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone (for up to two years after the termination of combatant activities). For officers, the exclusion amount is limited to the maximum enlisted amount. I.R.C. § 112(b)(1). This topic is covered in more detail in Chapter M.

XII. EXCLUSION – MILITARY AND VETERANS DISABILITY PAYMENTS

A. References: I.R.C. § 104(a)(4) & (b); Pub. 525, Taxable and Nontaxable Income.

B. Benefits paid by the U.S. Department of Veterans Affairs (VA) are tax-free. 38 U.S.C. § 5301(a)(1). 38 U.S.C. § 5301(a)(1) ("[p]ayments of benefits … under any law administered by [the VA] … shall be exempt from taxation"); *Wallace v. Comm'r*, 128 T.C. 132, 148-151 (2007)

C. Gross income does not include pension or annuity payments for personal injuries or sickness resulting from military service where (*i*) the payment was for a "combat-related injury"; or (*ii*) the taxpayer would be entitled upon application to receive VA disability compensation. I.R.C. § 104(a)(4), (b)(2)(C)-(D).

1. Combat-related injury. An injury that was the direct result of armed conflict, that occurred while engaged in extrahazardous service or under conditions simulating war, or that was caused by an instrumentality of war. I.R.C. § 104(b)(3).

2. Pension payments (or any portion thereof) based on years of service are not paid for a disability and thus are presumed taxable. Treas. Reg. § 1.104-1(e).

3. Accordingly, to exclude any portion of retirement pay, the taxpayer has the burden to show the pension was for a disability incurred during active service in the military. *Campbell v. Comm'r*, T.C. Summ. Op. 2014-109, at *15-17 (denying taxpayer's petition to exclude retirement pay from income where he could not establish his entitlement to VA disability compensation); *Holt v. Comm'r*, T.C. Memo. 1999-348, at *6 (citing *Scarce v. Comm'r*, 17 T.C. 830, 833 (1951)).

4. In most cases, DFAS will issue a Form 1099-R that already incorporates any proper income exclusions. The taxpayer should not make any assumptions to the contrary. *See, e.g., Taylor v. Comm'r*, T.C. Summ. Op. 2015-51, at *4-7; "Special Tax Considerations for Veterans," https://www.irs.gov/individuals/military/special-tax-considerations-for-veterans ("Under normal circumstances, the Form 1099-R issued to the veteran by Defense Finance and Accounting Services correctly reflects the taxable portion of compensation received. No amended returns would be required, since it has already been adjusted for any non-taxable awards."); *see also* IRS Appeals Settlement Guidelines, Military Disability Retirement Benefits (Dec. 19, 2012), https://www.irs.gov/individuals/military/special-tax-considerations-for-veterans.

   a. In certain circumstances, the taxpayer does not qualify to receive both retirement pay and VA disability compensation. In these cases, the taxpayer may elect to waive a portion of taxable retirement pay in favor of non-taxable VA disability compensation. 38 U.S.C. § 5305. DFAS will make appropriate adjustments to the taxpayer's Form 1099-R to account for the election.

      (1) Note that the statutory language of Section 104(b)(2)(D) and (b)(4) does not require the taxpayer to make an election or to actually have received VA disability compensation. The taxpayer instead must show that he or she "would be entitled" to the compensation. As shown by the *Campbell* case above, the taxpayer should assume that only documentation from the VA will satisfy this burden.

   b. Where the taxpayer qualifies for concurrent receipt of retirement pay and disability compensation, DFAS will make adjustments known as Combat Related Special Compensation (CRSC) or Concurrent Retirement and Disability Pay (CRDP). These amounts also are incorporated into the taxpayer's Form 1099-R.

5. Retroactive awards. The one instance where DFAS will not make appropriate adjustments is during the initial year of a retroactive VA award of disability compensation or increase thereof. In these circumstances, the taxpayer may file amended returns for any prior years that are not closed by the statute of limitations.

   a. The taxpayer must include with the amended returns a copy of the official VA Determination letter showing the amount withheld and effective date of the retroactive benefit. Pub. 525 (Sickness and Injury Benefits – Disability Pensions – Military and Government Disability Pensions).

b. A special statute of limitations applies to retroactive VA determinations. The taxpayer has one year from the date of the VA determination to amend any returns for years that begin no more than five years before the determination. I.R.C. § 6511(d)(8).

(1) Example. A taxpayer who receives a VA determination on 15 May 20X6 has until 15 May 20X7 to file amended returns for years 20X2 through 20X5. This is because five years before 15 May 20X6 is 15 May 20X1. Year 20X1 does not qualify because that year began before 15 May 20X1. However, year 20X2 began after 15 May 20X1 and therefore remains within the statute of limitations. The taxpayer may be entitled to refunds of tax attributable to any years encompassed within the effective date of the VA determination.

6. Amounts earned on or before September 24, 1975 are subject to lesser restrictions; namely, the taxpayer need only show that the payments in question were for injury or sickness resulting from military service. I.R.C. § 104(a)(4) & (b)(2)(A)-(B); *Holt v. Comm'r*, 1999 T.C. Memo. 348, at *6.

XIII. EXCLUSION – PAYMENTS FOR PERSONAL INJURY OR SICKNESS

A. References: I.R.C. § 104(a)(1)-(3) & (5)-(6); Pub. 525, Taxable and Nontaxable Income.

B. Gross income does not include payments under worker's compensation acts. I.R.C. § 104(a)(1).

1. A worker's compensation act is a law compensating employees for injuries or sickness incurred in the course of employment. Treas. Reg. § 1.104-1(a).

2. Worker's compensation does not include retirement pension or annuity payments to the extent the benefits are determined by reference to the employee's age, length of service, or prior contributions, even if the retirement is occasioned by occupational injury or sickness. Treas. Reg. § 1.104-1(b).

3. Recall, however, that worker's compensation payments that offset Social Security benefits are included within potentially taxable Social Security benefits. I.R.C. § 86(d).

C. Damages from settlements or judgments for physical injuries or physical sickness, whether paid as a lump-sum or in installments. I.R.C. § 104(a)(2).

1. "Physical" injury or sickness does not include emotional distress. I.R.C. § 104(a) (flush language).

2. The cost of medical care for emotional distress, however, is excludible. I.R.C. § 104(a) (flush language).

3. Punitive damages are taxable. I.R.C. § 104(a)(2).

D. Accident or health insurance payments for personal injuries or sickness. I.R.C. §§ 104(a)(3), 105(a).

1. The tax treatment depends on whether the taxpayer was subject to tax for the funds used to pay for premiums.

   a. In general, gross income does not include employer-provided coverage under an accident or health plan. I.R.C. § 106(a).

2. The amounts received generally represent taxable compensation if either [I.R.C. §§ 104(a)(3), 105(a)]:

   a. The taxpayer's employer paid for the premiums; or

   b. The employer excluded the premiums from the taxpayer's gross income.

3. If the taxpayer paid for the premiums or was taxed on the cost of premiums, the benefits received are tax-free.

4. Amounts received to reimburse the taxpayer for medical expenses, however, are not included in the taxpayer's gross income. I.R.C. § 105(b); Treas. Reg. § 1.105-2.

   a. If the taxpayer previously deducted the medical expenses as an itemized deduction, however, the reimbursement may represent taxable income in whole or part as a result of the tax benefit rule discussed above. I.R.C. § 111; Treas. Reg. § 1.105-2 (second sentence).

5. In general, long-term care insurance is treated as an accident or health insurance plan. I.R.C. § 7702B(a).

E. Terrorist or military action. A taxpayer may exclude from income disability payments attributable to injuries incurred as a direct result of a terroristic or military action. I.R.C. §§ 104(a)(5), 692(c)(2); Pub. 3920, Tax Relief for Victims of Terrorist Attacks.

XIV. OTHER GROSS INCOME EXCLUSIONS

A. U.S. Savings Bond interest used to pay education expenses.

1. References: I.R.C. § 135; Forms 1040, Schedule B and 8815.

2. A taxpayer who redeems a U.S. savings bond and uses the proceeds to pay qualified higher education expenses (QHEE) may exclude the interest income under the circumstances described below. Recall that the taxpayer normally pays no tax on the interest income until redemption of the bonds (see above).

3. QHEE include tuition and fees required for enrollment for the taxpayer, his or her spouse, or any dependent (for whom the taxpayer may claim a deduction under I.R.C. § 151). I.R.C. § 135(c)(2).

a. QHEE are reduced by:

(1) Scholarships excluded from gross income under I.R.C. § 117 [I.R.C. § 135(d)(1)(A)];

(2) Veterans' educational assistance benefits [I.R.C. § 135(d)(1)(B)];

(3) Tax-exempt educational assistance, such as employer-provided educational assistance and qualified tuition reductions [I.R.C. § 135(d)(1)(C)];

(4) Expenses use to calculate tax-free distributions from qualified tuition programs, as defined under I.R.C. § 529(b) (i.e., "529 plans") [I.R.C. § 135(d)(1)(D), (d)(2)(B)];

(5) Expenses used to claim the American Opportunity or Lifetime Learning credits under I.R.C. § 25A [I.R.C. § 135(d)(2)(A)]; and

(6) Expenses used to compute tax-free distributions from Coverdell Education Savings Accounts [I.R.C. § 135(d)(2)(B)].

b. Note. This "no double-counting" rule for QHEE is recurrent among other tax benefits for educational expenses. In other words, educational expenses normally may be used only to claim one form of tax benefit.

4. Where the redemption proceeds (including both principal and interest) exceed QHEE, the interest exclusion is reduced (pro-rated). Specifically, the proportion of the interest proceeds (IP) excluded from income equals the ratio of QHEE to the total proceeds (TP) of the bond redemption. In symbols, IP = {QHEE / TP}.

5. The interest exclusion under I.R.C. § 135 phases out over a range of $15,000 or $30,000 (MFJ) where the taxpayer's modified adjusted gross income (MAGI) exceeds statutory amounts of $40,000 or $60,000 (MFJ), as adjusted for inflation. I.R.C. § 135(b)(2). The inflation-adjusted ranges are published annually by the IRS.

6. The exclusion is not available to MFS taxpayers. I.R.C. § 135(d)(3).

7. The taxpayer reports the interest exclusion using Form 8815 and Schedule B.

B. Scholarships and Fellowships.

1. References: I.R.C. § 117; Treas. Reg. §§ 1.117-1 – 1.117-5; Pub. 970, Tax Benefits for Education.

2. Gross income does not include amounts received as a (*i*) qualified scholarship by (*ii*) a candidate for a degree at (*iii*) an eligible educational institution. I.R.C. § 117(a).

3. A "qualified scholarship" is an amount received by the taxpayer used to pay "qualified tuition and related expenses," are limited to the following: (*i*) "tuition and fees required for the enrollment or attendance"; and (*ii*) "fees, books, supplies, and equipment required for courses of instruction." I.R.C. § 117(b)(1)-(2).

4. Room and board, travel, and other expenses not listed above are taxable.

5. Any portion representing payment for services required by the scholarship, such as teaching, research, or other services. I.R.C. § 117(c)(1); Treas. Reg. § 1.117-2(a). The limited exceptions are:

    a. The National Health Service Corps Scholarship Program under Section 338A(g)(1)(A) of the Public Health Service Act [42 U.S.C. § 254l];

    b. The Armed Forces Health Professions Scholarship and Financial Assistance program under Subchapter I, Chapter 105 of Title 10 [10 U.S.C. § 2120 *et seq.*]; and

    c. A comprehensive student work-learning-service program under Section 448(e) of the Higher Education Act of 1965 [20 U.S.C. § 1087–58].

6. A "candidate for a degree" is (*i*) a primary or secondary school student; (*ii*) a university or college undergraduate or graduate pursuing studies or conducting research toward an academic or professional degree; or (*iii*) a full-time or part-time student at an educational organization that (*a*) provides full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation and (*b*) provides such a program under federal or state law and is accredited by a nationally recognized accreditation agency. Prop. Reg. § 1.117-6(b)(4), 53 Fed. Reg. 21688 (June 9, 1988); Pub. 970 (Scholarships, Fellowship Grants, Grants, and Tuition Reductions – Tax-Free Scholarships and Fellowship Grants) (listing requirements substantially the same as the 1988 proposed regulation); *see also* Treas. Reg. § 1.117-3(e) (stating that "candidate for a degree" includes secondary school or schooling allowing the student to meet the requirements of another institution's degree program).

7. An eligible education institution is one that "normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." I.R.C. § 170(b)(1)(A)(ii) (referenced in Section 117(a)).

8. Other scholarship and fellowship exclusions.

    a. Qualified tuition reductions. Tuition reductions available to employees of eligible institution are generally non-taxable. I.R.C. § 117(d).

b. Veterans educational programs. Educational benefits provided to veterans under programs operated by the U.S. Department of Veterans Affairs (VA). 38 U.S.C. § 5301(a)(1) ("[p]ayments of benefits … under any law administered by [the VA] … shall be exempt from taxation"); *Wallace v. Comm'r*, 128 T.C. 132, 148-151 (2007).

(1) As discussed elsewhere in this Deskbook, tax-free educational assistance from the VA may reduce other benefits. *See, e.g.*, I.R.C. § 25A(g)(2) (providing for reduction of expenses qualifying for education credits by amount of veterans' benefits); *Lara v. Comm'r*, T.C. Memo. 2016-96, at *5-6 & n. 2.

c. Military schools. Tuition and subsistence allowances to a military student at an educational institution operated by the United States or approved by the United States for education and training, e.g., the United States Naval Academy or the United States Military Academy. Treas. Reg. § 1.117-4(b).

C. Foreign Earned Income and Housing.

1. References: I.R.C. § 911; Treas. Reg. §§ 1.911-1 – 1.911-7; Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad; Form 2555.

2. A "qualified individual" may elect on Form 2555 to exclude from gross income up to a maximum annual amount (the "exclusion amount") of his or her "foreign earned income" and "housing cost amount."

3. Qualified individual. One whose tax home is in a foreign country and is either:

a. A bona fide resident of one or more foreign countries for an entire tax year [I.R.C. § 911(d)(1)(A)]; or

b. A United States citizen or resident present in one or more countries for at least 330 days during any 12-month period [I.R.C. § 911(d)(1)(B)].

4. Tax home. This is determined by reference to I.R.C. § 162(a)(2) and the test for establishing when the taxpayer is traveling away from home. I.R.C. § 911(d)(3). The taxpayer's "tax home" is usually the locale in which he or she works. *Commissioner v. Flowers*, 326 U.S. 465 (1946); *Mitchell v. Comm'r*, 74 T.C. 578, 581 (1980) (defining tax home as the "vicinity of the taxpayer's principal place of

employment" and distinguishing it from the location of the taxpayer's personal residence); Rev. Rul. 93-86, 1993-2 C.B. 71. Accordingly, the "tax home" requirement ensures that the foreign earned income exclusion is available only to those taxpayers whose work requires them to work overseas.

a. A taxpayer does not have a "tax home" in a foreign country if he or she maintains an "abode" in the United States.

(1) A taxpayer's "abode" is where he or she maintains "strong economic, familial, or personal ties" within the United States. *Harrington v. Comm'r*, 93 T.C. 297, 307-09 (1989). For example, an oil rig worker or pilot on a rotating 28-day schedule with no personal connection to a foreign jurisdiction other than employment will maintain an abode in the United States where family members, bank accounts, driver's licenses, and the like all remain within the United States. *Id.*; *Bellwood v. Comm'r*, T.C. Memo. 2019-135, at *17-21 (concluding that pilot on a roating 28-day schedule to Saudia Arabia maintained his "abode" in the United States and finding that petitioner's "only ties to Saudi Arabia were his contract for employment with PHI and a toaster oven that he purchased for his apartment").

(2) Exception. For tax years beginning in 2018, the "abode" restriction upon a taxpayer's "tax home" does not apply if the taxpayer is serving in a combat zone as designated by the President of the United States under I.R.C. § 112. In other words, contractors and employees of contractors qualify for the foreign earned income exclusion beginning in 2018. I.R.S. News Release IR-2018-173 (Aug. 24, 2018).

5. The "exclusion amount" is $80,000, which is adjusted for inflation and updated annually by the IRS. I.R.C. § 911(b)(2)(D)(i)-(ii).

6. Foreign earned income is compensation for personal services, such as wages, salary, and professional fees. I.R.C. § 911(d)(2)(A).

a. Foreign earned income does not pension or annuity amounts. I.R.C. § 911(b)(1)(A).

b. United States government salaries. Salaries paid to government employees, including all military salaries, do not constitute earned

income. Therefore, civilian and federal workers do not qualify for the foreign earned income exclusion.

7. The housing cost amount consists of the taxpayer's (*i*) housing expenses less (*ii*) 16 percent of the exclusion amount. The maximum housing expenses are capped at 30 percent of the taxpayer's exclusion amount. Using unadjusted, statutory amounts, a taxpayer with housing expenses of $30,000 therefore has a housing cost amount of $11,200:

   a. The housing expenses are capped at 30 percent of $80,000, i.e., {$80,000 × 30%} = $24,000.

   b. $30,000 > $24,000, so the cap applies.

   c. $24,000 – {$80,000 × 16%} = $11,200.

8. Where partial years are involved, the exclusion and housing cost amounts are computed on a daily basis. I.R.C. § 911(b)(2)(A), (c)(1)(B)(ii).

9. To qualify the individual must have a "tax home" in a foreign country. Note the following:

   a. The temporary presence of taxpayer in the U.S. or the maintenance of a dwelling in the U.S. does not mean an abode in the U.S. Treas. Reg. § 1.911-2.

   b. Contractors or employees of contractors providing support to the Armed Forces in designated combat zones may claim the foreign earned income exclusion, regardless of whether they maintain an abode in the United States. I.R.C. § 911(d)(3); I.R.S. Notice 2018-173 (Aug. 24, 2018).

10. Foreign income includes earned income from foreign sources.

    a. Place of receipt is immaterial.

    b. Income paid from U.S. Government sources or instrumentalities does not qualify.

11. Armed Forces assigned to NATO may not elect the foreign earned income exclusion for military compensation.

12. Election made on Form 2555.

D. Property acquired by gift, bequest, devise, or inheritance. References: I.R.C. § 102(a); Treas. Reg. § 1.102-1.

1. The Internal Revenue Code taxes the donor of such transfers where the amounts in question reach certain thresholds. I.R.C., Subtitle B, and §§ 2001, 2501, 2061.

2. Gifts from employers to employees are generally treated as either taxable compensation or excluded as fringe benefits. I.R.C. §§ 74, 132.

E. Life insurance proceeds are generally excluded from gross income. I.R.C. § 101(a).

XV. CONCLUSION

CHAPTER C

ADJUSTMENTS TO INCOME

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

I. REFERENCES

A. Internal Revenue Code (I.R.C.) §§ 62, 162, 164, 211-224.

B. Treasury Regulations.

C. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.

2. Pub. 17, Your Federal Income Tax.

3. Pub. 334, Tax Guide for Small Business.

4. Pub. 521, Moving Expenses.

5. Pub. 535, Business Expenses.

6. Pub. 590, Individual Retirement Arrangements (IRAs).

7. Pub. 969, Health Savings Accounts & Other Tax-Favored Health Plans.

8. Pub. 970, Tax Benefits for Higher Education.

D. IRS Forms 1040, Schedule 1, Schedule SE; Form 2106, Employee Business Expenses; Form 3903, Moving Expenses; Forms 1098-T and 1099-INT.

II. INTRODUCTION

A. Adjusted Gross Income (AGI). I.R.C. § 62. AGI is an individual's gross income less the deductions specified in Section 62. The term "adjustments to income," which appears on Form 1040, is not used in I.R.C. § 62.

B. The distinction is between adjustments and deductions is nevertheless helpful because deductions that determine AGI (also known as deductions "for" AGI) operate differently from itemized deductions (deductions "from" AGI), which are discussed in Chapter D.

1. First, where a taxpayer qualifies to claim an "adjustment," the deduction is allowed regardless of whether the taxpayer chooses to itemize deductions or to claim the standard deduction.

2. In addition, itemized deductions often change in amount based on the taxpayer's income; for example, medical expenses are deductible only to the extent they exceed a specified percentage of AGI.

3. Accordingly, an adjustment has a cascading impact: it reduces AGI, which in turn may increase the amount of itemized deductions.

C. Deductions that determine AGI are frequently known as "above-the-line" deductions because they appear on Form 1040 before the line reporting AGI.

1. The term "above the line" should not be interpreted to imply that all adjustments appear on Form 1040. For example, business expenses reported by a self-employed taxpayer or rental expenses of a landlord appear only on Schedules C and E, respectively. These deductions, however, are deductions under I.R.C. § 62 and hence "adjustments."

III. EDUCATOR EXPENSE DEDUCTION

A. An "eligible educator" may claim an adjustment for unreimbursed "qualified expenses." I.R.C § 62(a)(2)(D).

1. An eligible educator is a K-12 teacher, instructor, counselor, principal, or aide who worked in a school for at least 900 hours during the school year. I.R.C. § 62(d)(1)(A).

2. "Qualified expenses" are those paid:

a. For professional development courses related to the curriculum taught (or to the students) [I.R.C. § 62(a)(2)(D)(i)]; or

b. In connection with books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom [I.R.C. § 62(a)(2)(D)(ii)].

3. Qualified expenses do not include:

a. Nonathletic supplies for courses of instruction in health or physical education. I.R.C. § 62(a)(2)(D)(ii).

b. Home schooling.

(1) An eligible educator must work in a "teacher, instructor, counselor, principal, or aide" at a "school." I.R.C. § 62(d)(1)(A).

(2) A "school" means one that provides "elementary education or secondary education, as determined under State law." I.R.C. § 62(d)(1)(B).

(3) See also Pub. 17 (Education-Related Adjustments – Educator Expenses) ("Qualified expenses don't include expenses for home schooling.").

4. Double-counting restriction based other education-related tax benefits. I.R.C. § 62(d)(2). The educator expense adjustment is only allowed to the extent the amount exceeds:

a. Interest from U.S. Savings bonds excluded from income under I.R.C. § 135 (See Chapter B); and

b. Non-taxable earnings from 529 accounts and Coverdell Education Savings accounts (See Chapter I).

B. The statutory amount of the deduction is limited to $250, which is adjusted for inflation. I.R.C. § 62(d)(3).

1. The maximum is $500 if married filing joint and both spouses are educators.

2. If both spouses are educators, each spouse is limited to $250.

IV. RESERVE/NATIONAL GUARD TRAVEL EXPENSES

A. If a Reserve or National Guard member must travel more than 100 miles from home for duty, he or she may deduct travel expenses, including per diem in lieu of subsistence, up to limits authorized for employees of federal agencies under 5 U.S.C. § 5701 *et seq.* I.R.C. §§ 62(a)(2)(E), 162(p).

B. Permissible travel expenses.

1. Lodging and meals and incidental expenses (M&IE) up to the regular federal per diem rate;

2. Car expenses, up to the standard mileage rate; and

3. Parking fees, ferry fees, and tolls.

C. Note: For most taxpayers, unreimbursed travel expenses incurred on behalf of their work as employees are miscellaneous itemized deductions and non-

deductible for years 2018 through 2025. (See Chapter D.) Reserve and National Guard travel expenses for travel of 100 miles or less fall into this same category and thus are non-deductible for years 2018 through 2025.

D. The taxpayer must report the travel expenses on Form 2106 and Schedule 1, Part II. of Form 1040.

V. HEALTH SAVINGS ACCOUNTS

A. I.R.C. § 223 permits eligible individuals to establish Health Savings Accounts (HSAs). HSAs are like IRAs created for the purpose of defraying unreimbursed health care expenses on a tax-favored basis. An HSA is a tax-exempt trust or custodial account with a financial institution where the taxpayer saves for future medical expenses. The interest or earnings on the assets are tax-free.

B. Within the limits, contributions to an HSA will be deductible if made by an eligible individual as an above-the-line deduction (Form 8889) and excludable from income if made by an employer on behalf of an eligible individual. If the employer makes the contribution on behalf of the employee, the amount of the contribution is not deductible by the employee as an HSA contribution or as a medical expense deduction.

C. Distributions from an HSA are tax-free when used to pay for qualified medical expenses. Distributions not used to pay for qualified medical expenses are penalized (10%), as well as taxed unless the taxpayer is disabled, over 65, or dies during the year.

1. Qualified medical expenses are unreimbursed expenses paid by the account beneficiary, his or her spouse, or his or her dependents for medical care as defined in I.R.C. § 213(d). Nonprescription drugs (other than insulin) are not included as a qualified medical expense. I.R.C. § 223(d)(2)(A).

2. Qualified medical expenses must be incurred after the HSA has been established.

3. For purposes of determining the itemized deduction for medical expenses, medical expenses paid or reimbursed by distributions from an HSA are not

treated as expenses paid for medical care under I.R.C. § 213 (i.e. are not deductible as itemized expenses for medical care).

D. To qualify for an HSA deduction, taxpayer must meet all of the following requirements:

1. Must be covered under a high deductible health plan (HDHP) on the first day of the month.

   a. An HDHP is a plan that has an annual deductible exceeding certain amounts published by the IRS, as well as a maximum annual deductible and out-of-pocket expenses that do not exceed certain specified amounts.

2. Must not be covered by any other health plan that is not an HDHP (there are certain exceptions).

3. Must not be enrolled in Medicare (generally has not reached age 65).

4. May not be claimed as a dependent on another person's tax return.

E. With certain exceptions, an individual is ineligible for an HSA if the individual, while covered under an HDHP, is also covered under a health plan (whether as an individual, spouse, or dependent) that is not an HDHP.

F. The maximum contribution eligible taxpayers can make to an HSA is the sum of the limits determined separately for each month, based on status, eligibility, and health plan coverage as of the first day of the month. See Form 8889 Instructions.

1. In addition to the maximum contribution amount, catch-up contributions may be made by or on behalf of individuals age 55 or older, who are not enrolled in Medicare. The catch-up contribution limit is $1,000 for those eligible for catch-up contributions. There is no requirement that the individual have earnings.

2. After an individual has attained age 65 (the Medicare eligibility age), contributions, including catch-up contributions, cannot be made to an individual's HSA.

3. Contributions that exceed the established limits are not deductible. In addition, an excise tax of 6% for each taxable year is imposed on the account beneficiary for excess individual and employer contributions unless the excess contributions and the net income attributable to the excess contributions are paid to the account beneficiary before the day prescribed for filing the federal income tax return.

VI. MOVING EXPENSES

A. An employee or self-employed individual may deduct as an adjustment to income the expenses of moving himself or herself and family members from one location to another if the move is related to starting work in a new location and the amount is reasonable. I.R.C. § 217.

B. The law commonly known as the Tax Cuts and Jobs Act (TCJA) suspended the moving expense adjustment for all non-military taxpayers for years 2018 through 2025. I.R.C. § 217(k); An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, § 11049, 131 Stat. 2054 (Dec. 22, 2017).

1. Through tax year 2025, the adjustment is retained for active duty military members who move "pursuant to a military order and incident to a permanent change of station." I.R.C. § 217(g).

2. Before the suspension of the moving expenses adjustment, civilian taxpayers were subject to certain distance and time requirements (i.e., they had to move a certain distance for reasons of employment and remain employed for a specified period of time). I.R.C. § 217(c), (d); Treas. Reg. § 1.217-2(a)(3), (d)(3). The distance and time requirements do not apply to military members to whom the adjustment still applies. I.R.C. § 217(g)(1).

C. Generally, deductible moving expenses are limited to the <u>unreimbursed</u> costs of:

1. Transportation of household goods and personal effects. I.R.C. § 217(b)(1)(A).

a. This includes the costs of packing and crating these items, as well as in-transit storage and insurance expenses within any period of

30 consecutive days after the day goods are moved from the former home and before they are delivered to the new home. Treas. Reg. § 1.217-2(b)(3).

b. Costs of connecting or disconnecting utilities required because of the move, shipping of car, and pet. Treas. Reg. § 1.217-2(b)(3).

2. Travel (lodging, but not meals) to the new residence. I.R.C. § 217(b)(1)(B).

a. Lodging expenses in the area of the former residence within one day after the taxpayer could not live in the former home because of the removal of household goods and personal effects. Treas. Reg. § 1.217-2(b)(4).

b. Lodging expenses for the day arriving at the new place of residence. Treas. Reg. § 1.217-2(b)(4).

D. Where an automobile is used in making the move (Form 3903 Instructions):

1. One of the following:

a. Actual out-of-pocket expenses, i.e., gasoline and oil (not repairs, depreciation, etc.); or

b. Standard mileage allowance, as established by statute and published annually by the IRS.

2. Tolls.

3. Parking.

E. Moving expenses do <u>not</u> include incidental costs other than transportation and lodging. Nondeductible expenses include any purchase or selling expenses for the former or new residence, home improvements, lease termination expenses, car

tags, driver's licenses, mortgage penalties, real estate taxes, and return trips to former residence. Form 3903 Instructions.

F. Individuals that retire from an overseas job and return to the United States or a survivor (spouse or dependent) of any decedent who worked outside the United States (including United States possessions) at the time of death are also eligible to deduct moving expenses if, within six months of the decedent's death, the survivor moves to the U.S. from a foreign residence that had been shared by the decedent. I.R.C. § 217(i).

G. Foreign moves. The rules are similar to the general moving expense deductions rules, except that a deduction is also allowed for:

1. Reasonable expenses of moving household goods and personal effects from storage [I.R.C. § 217(h)(1)(A)]; and

2. Storing them for part or all of the time during which the new place of work abroad continues to be a taxpayer's principal place of work [I.R.C. § 217(h)(1)(B)].

H. Moving expenses of members of the Armed Forces. I.R.C. § 217(g).

1. A permanent change of station for purposes of this section includes:

a. A move from a home to the first post of active duty;

b. A move from one permanent post of duty to another; and

c. A move from the last post of duty to a home or to a nearer point in the U.S. The move must occur within one year of ending of active duty or within the period allowed under the Joint Travel Regulations.

I. The moving expense deduction is computed on Form 3903, and the result is carried over to Form 1040, Schedule 1, Part II.

VII. DEDUCTIBLE PART OF SELF-EMPLOYMENT TAX

A. If an individual is subject to the self-employment tax, the taxpayer may deduct from gross income the employer-equivalent portion (50%) of the self-employment tax imposed for the same tax year. I.R.C. § 164(f). The self-employment tax rate for 2018 is 15.3% (10.4% for Social Security and 2.9% for Medicare). Taxpayers cannot deduct the 0.9% Additional Medicare Tax. I.R.C. § 164(f)(1).

B. The taxpayer completes Schedule SE to determine the amount of self-employment tax to enter on Form 1040.

VIII. SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

A. Some taxpayers may be able to deduct part of the amount paid for health insurance for themselves, spouse, and dependents if:

1. The taxpayer was self-employed and had a net profit for the tax year; or

2. The taxpayer received wages from an S-Corporation in which he or she is more than a 2% shareholder. I.R.C. § 162(l)(1), (5).

B. The amount of the deduction is 100% of the total amount of health insurance coverage paid in the tax year. However, the deduction is limited to the taxpayer's earned income derived from the trade or business for which the insurance plan was established. I.R.C. § 162(l)(2)(A).

C. A self-employed person's health insurance deduction is treated separately with regard to plans that provide long-term care insurance and plans that do not provide long-term care insurance. I.R.C. § 162(l)(2)(B).

D. The amount of the deduction is computed using the worksheet in the instruction booklet for Form 1040 and then included as a deduction or adjustment to income on Form 1040, Schedule 1.

IX. PENALTY ON EARLY WITHDRAWAL OF SAVINGS

A. Interest that was previously earned on a time savings account or deposit with a savings institution and is later forfeited because of a premature withdrawal is deductible from gross income in the year when the interest is forfeited. I.R.C. § 62(a)(9).

B. Form 1099-INT or Form 1099-OID report the interest earned, as well as any early withdrawal penalties.

C. Taxpayers cannot net the early withdrawal penalty against the interest income earned for the year. The early withdrawal penalty is separately claimed as an adjustment to income on Form 1040, Schedule 1, Part II.

X. ALIMONY PAID

A. The TCJA (cited above) significantly changed the tax treatment of alimony for decrees of divorce executed after 31 December 2018, or those agreements modified after that date that make the new provision applicable. For decrees after 31 December 2018, the payor spouse does not deduct the payment, and the recipient spouse does not report the payment as income. This mirrors the tax treatment of child support payments. <u>The discussion below is therefore applicable only to decrees entered on or before 31 December 2018</u>. See also Chapter B.

B. For pre-2019 decrees, the payor deducts alimony as an adjustment to income, and the recipient must include the amount in gross income. I.R.C. §§ 62(a)(10), 71, and 215 (before repeal by Pub. L. No. 115-97 (Dec. 22, 2017) (hereafter "Former Section 62(a)(10)," "Former Section 215," and "Former Section 71"). See Chapter B.

C. To qualify as alimony, the payments must satisfy the following requirements:

1. Payment must be in cash either to the spouse or a third-party on the spouse's behalf (in the latter scenario, the payor, for example, may pay a medical provider or landlord, rather than pay the spouse who will use the funds for the same purpose). Former Section 71(b)(1).

2. Under a (*i*) decree of divorce or separate maintenance, or one that otherwise obligates one spouse to pay for the other's support or

maintenance, or (*ii*) a written separation agreement. Former Section 71(b)(2).

3. The agreement must not designate the payment as excludable from gross income and disallowed as a deduction. Former Section 71(b)(1)(B).

4. If legally separated under a decree of divorce or separate maintenance, the spouses must not be members of the same household. Former Section 71(b)(1)(C).

5. The payor must have no obligation to make any payment (cash or property) after the payee's death. Former Section 71(b)(1)(D).

6. The instrument must not fix payment amounts or otherwise be contingent upon amounts due for child support. Former Section 71(c)(1)-(2).

7. The spouses must not file a joint return. Former Section 71(e).

D. Where a divorce or separation agreement imposes both alimony and child support obligations, underpayments constitute child support before qualifying as alimony. Former Section 71(c)(3).

E. If the amount of child support is not specified in the instrument, the amount to be decreased upon a contingency relating to a child will be treated as child support.

1. I.R.C. § 71(c) reversed the rule in *Comm'r v. Lester*, 366 U.S. 299 (1961); *see Kean v. Comm'r*, 407 F.3d 186, 190 (3d Cir. 2005). Contingencies relating to a child include reaching the age of majority, marriage, death, earning specified income level, gaining employment, and leaving the home of custodial parent.

F. The payor taxpayer deducts alimony received on Form 1040, Schedule 1, Part II. The taxpayer must include the recipient's Social Security number and the date of the divorce or separation instrument.

XI. STUDENT LOAN INTEREST DEDUCTION

A. A taxpayer may claim an adjustment to income (i.e., an above-the-line deduction) for interest paid on qualified educational loans. A loan and any refinancing of that loan are treated as one loan. I.R.C. §§ 62(a)(17), 221; Treas. Reg. §1.221-1(e)(3)(v)(A).

B. The maximum deduction allowed is a non-inflation-adjusted, statutory amount of $2,500 per tax return (not per student). I.R.C. § 221(b)(1).

C. The deduction phases out ratably for taxpayers with modified AGI (MAGI) exceeding statutory amounts of $50,000 or $100,000 (married filing jointly), as adjusted for inflation and published annually by the IRS. I.R.C. § 221(b)(2), (f).

D. MAGI is AGI as determined:

1. Without regard to student loan interest paid, amount of any tuition and fees deduction (I.R.C. § 222), and any exclusions for income earned in foreign countries or United States territories (I.R.C. §§ 911, 931, 933). I.R.C. § 221(b)(2)(C)(i).

2. After applying the Social Security benefits inclusion, the exclusion for U.S. Savings Bonds used to pay education expenses, the adoption expenses exclusion, the IRA deduction, and the passive loss rules (I.R.C. §§ 86, 135, 137, 219, 469). I.R.C. § 221(b)(2)(C)(ii).

E. The student loan interest deduction may be claimed only by a taxpayer that is legally obligated to make the interest payments pursuant to the terms of the loan. Treas. Reg. § 1.221-1(b)(1).

F. An eligible student is one who [I.R.C. § 221(d)(3); Treas. Reg. § 1.221-1(f)(3)(i)(C)]:

1. Is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad that is approved for credit by the institution at which the student is enrolled) leading to a recognized educational credential at an eligible education institution; and

2. Is carrying at least one-half the normal full-time workload for the course of study the student is pursuing.

G. A person who is claimed as a dependent on another's tax return may not claim the education interest deduction. I.R.C. § 221(c).

H. Married couples must file joint returns to take the deduction. I.R.C. § 221(e)(2).

I. A qualified higher education loan is any debt incurred to pay qualified higher education expenses that are [I.R.C. § 221(d)(1)(A)-(C)]:

1. Incurred on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the debt is incurred;

2. Paid or incurred within a reasonable period of time before or after the debt is incurred (90 days before or after the academic period); and

3. Attributable to education furnished during a period when the recipient was an eligible student (at least half-time student).

J. A qualified education loan includes debt used to refinance debt that qualifies as a qualified education loan, but does not include debt owed to a related person as defined by I.R.C. § 267(b).

K. A revolving line of credit will qualify as an education loan only if the borrower agrees to use it only for qualified higher education expenses.

L. Qualified higher education expenses are the costs of attendance at an eligible educational institution, which is generally a post-secondary educational institution eligible to participate in the federal student loan program. An eligible educational institution also includes one conducting an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility which offers postgraduate training. I.R.C. § 221(d)(2); Treas. Reg. § 1.221-1(e)(1).

M. Qualified higher education expenses include tuition, fees, room and board, and related expenses, but must be reduced by the amount excluded by reason of such expenses under the rules for employer-provided educational assistance benefits,

income from U.S. Savings Bonds used to pay higher education expenses, distributions from an education IRA, Veteran's Benefits, and scholarships or fellowship grants. I.R.C. § 221(d)(2), Treas. Reg. § 1.221-1(e)(2).

N. No deduction is allowed under this section for any amount for which a deduction is allowable under any other provision of the Code (such as a home equity loan). I.R.C. § 221(e)(1).

XII. TUITION AND FEES DEDUCTION

A. Tax extender provision set forth in I.R.C. § 222. See Pub. 970; Form 8917.

B. The tuition and fees deduction is an adjustment to income for qualified education expenses paid during the year, including a prepayment for a semester that begins within first three months of following year. I.R.C. § 222(a), (d)(3).

1. Qualified education expenses.

a. Tuition and related expenses required for enrollment or attendance at an eligible educational institution. I.R.C. § 222(d)(1) (referencing I.R.C. § 25A(f)).

b. Student activity fees and expenses for course-related books, supplies, and equipment included only if they must be paid to the institution as a condition of enrollment or attendance.

2. Ineligible expenses: room and board, insurance, transportation, or courses that are not required to achieve a degree, as well as expenses paid for sports, games, and hobbies, even if required by the institution.

C. Statutory deduction limits (not adjusted for inflation). I.R.C. § 222(b)(2).

1. For MAGI up to $65,000 ($130,000 MFJ): $4,000.

2. For MAGI up to $80,000 ($160,000 MFJ): $2,000.

3. MAGI greater than $80,000 ($160,000 MFJ): no deduction.

D. Disqualifying circumstances:

1. Taxpayer files married filing separately.

2. For same student, an American Opportunity Tax Credit or Lifetime Learning Credit is claimed. I.R.C. § 222(c)(1).

3. Expenses for deduction are used to claim another educational tax benefit, such as a tax-free distribution from a Section 529 account. I.R.C. § 222(c)(2).

XIII. CONCLUSION

CHAPTER D

STANDARD AND ITEMIZED DEDUCTIONS AND TAX COMPUTATION

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I. REFERENCES

A. Internal Revenue Code (I.R.C.), §§ 163-170, 212-213.

B. Treasury Regulations (Treas. Reg.).

C. IRS Publications:

1. Pub. 17, Your Federal Income Taxes.

2. Pub. 501, Dependents, Standard Deduction, and Filing Information

3. Pub. 502, Medical and Dental Expenses.

4. Pub. 526, Charitable Contributions.

5. Pub. 529, Miscellaneous Deductions.

6. Pub. 530, Tax Information for Homeowners

7. Pub. 547, Casualties, Disasters, and Thefts.

8. Pub. 550, Investment Income and Expenses.

9. Pub. 936, Home Mortgage Interest Deduction.

D. Form 1040, Schedule A and Instructions.

II. STANDARD DEDUCTION

A. Basic standard deduction. The standard deduction is a fixed amount, based primarily on the taxpayer's filing status, that reduces adjusted gross income (AGI). The fixed amounts are set forth by statute and then adjusted for inflation and updated annually by the IRS. I.R.C. § 63(c)(2), (c)(4).

Filing Status	Standard Deduction Amount (Statutory)
Single	$6,000
Married filing jointly/qualifying widow(er)	$6,000
Head of household	$4,400
Married filing separately	$3,000

B. The tax law commonly known as the Tax Cuts and Jobs Act ("TCJA") increased the standard deduction amount for each filing status for years 2018 through 2025 to the statutory amounts set forth below. An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017); I.R.C. § 63(c)(7). The amounts are adjusted for inflation beginning in 2019.

Filing Status	Standard Deduction Amount (Statutory)
Single	$12,000
Married filing jointly/qualifying widow(er)	$24,000
Head of household	$18,000
Married filing separately	$12,000

C. Additional Standard Deduction Amounts. I.R.C. § 63(f). Taxpayers who are age 65 (as of 1 January or earlier) or over or who are blind (of any age) (as of 1 January or earlier) qualify for a larger standard deduction. I.R.C. § 63(c)(1), (c)(3). The increase is adjusted for inflation and published by the IRS. This additional standard deduction amount is per-disability: "[f]or example, a single taxpayer who is age 65 and blind would be entitled to a basic standard deduction and an additional standard deduction equal to the sum of the additional amounts for both age and blindness." IRS Tax Topic No. 551, https://www.irs.gov/taxtopics/tc551.

D. Standard Deduction for Dependents. I.R.C. § 63(c)(5). A dependent is entitled to a standard deduction on the dependent's return of the greater of a statutory amount of $500, adjusted for inflation and published annually by the IRS; or the dependent's earned income plus a statutory amount of $250 (also adjusted for inflation). This amount is increased if the dependent is age 65 or older or blind.

1. A "dependent" is defined in I.R.C. § 152. Most relatives of the taxpayer qualify as a "dependent" if the taxpayer provides over half the support (children, parents, grandparents, etc.).

   a. A spouse is not a dependent for federal income tax purposes.

2. Earned income includes wages, salary, tips, professional fees, other compensation, and any amount received as a scholarship that must be included in income.

3. Note: The following are not eligible for the basic standard deduction. I.R.C. § 63(c)(6):

   a. Married filing separate where either spouse itemizes.

   b. Nonresident alien.

   c. Taxpayer who changes accounting period and is required to file a return for less than 12 months.

   d. Estate, trust, or partnership.

III. ITEMIZED DEDUCTIONS – GENERALLY

A. Itemized versus standard deduction.

1. If itemized deductions are less than the standard deduction, taxpayer should claim the standard deduction. A taxpayer may claim the higher amount after-the-fact by filing an amended return on Form 1040-X.

2. Itemized deductions are strictly construed and are not allowable unless expressly authorized in the Internal Revenue Code. I.R.C. § 63(a); *see also, e.g., New Colonial Ice Co., Inc. v. Helvering*, 292 U.S. 435, 440 (1934).

3. The taxpayer bears the burden of proving entitlement to any deductions claimed. *See, e.g., Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943).

B. Except for years 2018 through 2025, where the provision is suspended, itemized deductions are subject to phase-out for higher-income taxpayers. I.R.C. § 68(a), (f).

1. The phase-out begins at statutory amounts of $250,000 (single), $275,000 (head of household), or $300,000 (joint returns), as applicable. I.R.C. § 68(b)(1). These amounts are adjusted for inflation and published annually by the IRS, except for years 2018 through 2025. I.R.C. § 68(b)(2).

2. The phase-out equals 3 percent over the threshold amount up to a maximum of 80 percent of the itemized deductions otherwise allowable. I.R.C. § 68(a)(1)-(2).

C. Note. Taxpayers generally may not claim a deduction for expenses paid with tax-exempt income. I.R.C. § 265. Accordingly, investment interest (discussed later) cannot be deducted to the extent paid with income from tax-exempt interest. Similarly, a nonresident alien not subject to tax on income from outside the United States may not claim a deduction for foreign taxes paid.

D. Qualified Business Income (QBI) deduction. I.R.C. § 199A; Forms 8995 and 8995-A.

1. Upon a reduction in corporate rates in 2018, Congress added a 20% for non-corporate taxpayers. The deduction is available for net income from a trade or business (not from performing employee services). I.R.C. § 199A(d)(1)-(2).

2. An individual taxpayer also may claim this deduction if he or she receives income from a qualified real estate investment trust (REIT) or publicly traded partnership (PTP). The amount will be reported on Form 1099-DIV.

3. Taxpayers with taxable income exceeding statutory amounts of $157,500 ($315,000 for married filing jointly), as adjusted for inflation, are subject to complex set of rules limiting the deduction and must file form Form 8995-A.

4. A simplified form is available to compute the QBI deduction for taxpayers not subject to the thresholds. For taxpayers under the applicable thresholds, the deduction is the lesser of [I.R.C. § 199A(a)(2)]:

a. 20% of QBI, plus 20% of any dividends from qualified real estate investment trusts or publicly traded partnerships; or

b. 20% of taxable income less net capital gain.

IV. MEDICAL AND DENTAL EXPENSES

A. References: I.R.C. § 213; Treas. Reg. § 1.213-1; Pub. 502.

B. Medical expenses qualifying for the deduction are listed below. I.R.C. § 213(d) (definition of "medical care").

1. Diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body;

2. Transportation costs on a trip taken primarily for and essential to medical care as specified above;

3. Medical insurance for:

a. The above expenses, including Medicare B (supplemental medical insurance) and Medicare D (voluntary prescription drug insurance); or

b. A qualified long-term care insurance contract; and

4. Qualified long-term care services.

a. Qualified long-term care services are [I.R.C. §§ 213(d)(1)(C), 7702B(c)(1)]:

(1) Diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services, that:

(a) Are required by a chronically ill individual; and

(b) Are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

C. Limitation on overall deduction amount. Medical expenses are deductible only if they exceed a threshold percentage of AGI, usually either 7.5% or 10%, depending on the tax year.

1. See Pub. 17, Form 1040, Schedule A, or other annual IRS guidance for the applicable threshold.

D. Limitations on includible expenses.

1. General limitations.

a. The expenses must actually be paid during the year, regardless of when incurred. I.R.C. § 213(a) ("expenses paid during the taxable year"); Treas. Reg. § 1.213-1 ("if the medical expenses are incurred but not paid during the taxable year, no deduction for such expenses shall be allowed for such year").

b. The expenses must be not be reimbursed. I.R.C. § 213(a) (allowing deduction only for expenses "not compensated by insurance or otherwise").

2. Expenses not for medical care.

a. Costs of medicine and drugs are included only if prescribed by a doctor or for insulin. I.R.C. § 213(b).

b. Expenses of cosmetic surgery, which are procedures designed to improve appearance and not to promote the proper bodily functions or prevent or treat illness or disease, are not deductible. I.R.C. § 213(d)(9)(A)-(B).

(1) Procedures to ameliorate the consequences of a congenital abnormality, a personal injury from accident or trauma, or a disfiguring disease are deductible. I.R.C. § 213(d)(9)(A).

c. Expenses that do not meet the definition of medical care.

(1) Pub. 502 contains a detailed list of deductible and nondeductible expenses. Nondeductible expenses typically include a

substantial personal consumption element. Disallowed expenses include babysitting, dance lessons, health club dues, cosmetics, maternity clothes, nonprescription medicines, and nutritional supplements.

3. Limits on transportation costs

a. Mileage rate. Travel costs for medical care are deductible at a mileage rate established by the IRS each year.

b. Meals and lodging are not deductible, except if included within the cost of in-patient hospital care. Treas. Reg. § 1.213(e)(1)(iv)-(v).

(1) Limited carve-out for lodging. Lodging expenses outside of a hospital away from home primarily for and essential to medical may be deducted where the lodging [I.R.C. § 213(d)(2)]:

(a) Is not extravagant or lavish;

(b) Contains no element of personal pleasure, recreation, or vacation; and

(c) Is $50 or less per night.

c. Costs for travel for general improvement of health, such as travel to a warm climate, are not deductible. Treas. Reg. § 1.213(e)(1)(iv).

d. Elective travel costs to another locality for medical (e.g., a resort area) are not deductible. Treas. Reg. § 1.213(e)(1)(iv).

4. Limits on medical insurance.

a. Qualified long-term care insurance contracts.

(1) A qualified long-term care insurance contract is one that covers qualified long-term care services (see below) and meets other requirements stated in I.R.C. § 7702B(b)(1).

(2) Deductible premiums for a qualified long-term care insurance contracts are limited to "eligible long-term care premiums." I.R.C. § 213(d) (flush language).

(3) Eligible long-term care premiums are those that do not exceed a statutory amount that is adjusted for inflation and published annually by the IRS. I.R.C. § 213(d)(10).

b. Insurance premiums not based on medical expenses are not deductible. This includes income-replacement insurance or other insurance contracts not based on the amount of medical expenses incurred.

E. Individuals whose expenses qualify for the deduction. The taxpayer may deduct:

1. His or her own medical expenses.

2. Medical expenses of a spouse, if married either when medical services are rendered or when expenses are paid.

3. Medical expenses of a dependent, if the individual is a dependent of the taxpayer either at the time medical services are rendered or when paid.

a. "Dependent" is defined by the dependency exemption rules under I.R.C. § 152, but the exclusions of § 152(b)(1), (b)(2), and (d)(1)(B) do not apply.

(1) In other words, if the other dependent tests are met, an individual qualifies as a dependent even if he or she (*i*) can be claimed as a dependent by another taxpayer, (*ii*) files a joint return with another taxpayer, or (*iii*) has AGI above the applicable exemption amount.

b. Special rule for child of divorced parents. A child is treated as a dependent of both parents if the child meets the requirements of I.R.C. §152(e). I.R.C. § 213(d)(5). This means the parent who pays the qualifying medical expenses may claim them, even if not claiming the dependency exemption for the child.

V. TAXES

A. References: I.R.C. § 164; Treas. Reg. §§ 1.164-1 – 1.164-6; Pub. 530.

B. Note. For tax years 2018 through 2025, the personal deduction for state and local taxes is limited to a total of $10,000 per year ($5,000 if married filing separately). I.R.C. § 164(b)(6)(B). In addition, the deduction of foreign real property taxes is disallowed for the same period. I.R.C. § 164(b)(6)(A).

C. General rules.

1. The taxpayer may deduct only the types of taxes specifically listed in the Internal Revenue Code. As discussed below, these generally include state and local real property tax; state and local personal property tax; and state and local income tax, or, at the taxpayer's election, general sales tax.

2. To claim an itemized deduction for taxes paid, the taxpayer generally must be the individual liable for the tax. Treas. Reg. § 1.164-1(a) ("In general, taxes are deductible only by the person upon whom they are imposed.").

a. Exceptions.

(1) In narrow circumstances where a person has an equitable or beneficial interest in real property and has assumed the benefits and burdens of ownership, the individual may qualify to claim real estate tax (and mortgage interest) deductions in connection with that property. *Trans v. Comm'r*, T.C. Memo. 1999-233, at *15-16 (concluding that taxpayers qualified to deduct interest and taxes where they paid all expenses of the property, but the property was titled in another individual's name to enable them to obtain a mortgage) (citing *Estate of Movius v. Comm'r*, 22 T.C. 391 (1954) and other cases).

(2) Where sales taxes are deductible in lieu of state or local income tax (see below), a separately stated sales tax, even levied upon the seller, is treated as a tax paid by the consumer. I.R.C. § 164(b)(5)(G).

D. A taxpayer may claim, if paid during the year, an itemized deduction for the following taxes (a few less-common taxes are omitted below):

1. State and local real property taxes (foreign real property taxes before 2018 and after 2025). I.R.C. § 164(a)(1).

2. State and local personal property taxes. I.R.C. § 164(a)(2).

3. State, local, and foreign income taxes. I.R.C. § 164(a)(3).

a. The taxpayer may elect to deduct state and local general sales tax in lieu of income tax. I.R.C. § 164(b)(5)(A).

(1) A general sales tax is one that imposed at a single rate upon retail sales of a broad class of items. I.R.C. § 164(b)(5)(B).

(a) A tax is not disallowed if the state charges lower rates (or no rate) upon food, clothing, medical supplies, and motor vehicles. I.R.C. § 164(b)(5)(C).

(b) However, where the tax rate on automobiles exceeds the general rate, only the general rate is deductible. I.R.C. § 164(b)(5)(F).

(c) Moreover, no tax deduction is allowed for tax upon particular items taxed at special rates. I.R.C. § 164(b)(5)(D).

(2) A compensating use tax is treated as a general sales tax if it is complementary to such a tax and imposed on the use, storage, or consumption of an item. I.R.C. § 164(b)(5)(E).

(3) In lieu of actual sales tax paid during the year, the taxpayer may elect to determine the amount of his or her deduction pursuant to tables established by the IRS based on filing status, dependents, AGI, and state and local sales tax rates. *See* I.R.C. § 164(b)(5)(H). Large-ticket items, including motor vehicles, boats, and other items specified by the IRS, are added separately. I.R.C. § 164(b)(5)(H)(i)(I). *See* Instructions for Form 1040,

Schedule A, Optional State Sales Tax Tables & Optional Local Sales Tax Tables.

E. Real property taxes.

1. Deductible real property taxes are those imposed on interests in real property and levied for the general public welfare. Treas. Reg. § 1.164-3(b).

2. Accordingly, special assessments and similar taxes that tend to increase the value of the property assessed are not deductible. I.R.C. § 164(c)(1).

a. Exception. Special assessments for maintenance or interest charges are deductible. I.R.C. § 164(c)(1).

3. Sale of real property.

a. In the year of sale, the seller and buyer are entitled to deductions for their respective periods of ownership on a daily basis. I.R.C. § 164(d)(1)(A)-(B).

b. The day of sale is allocated to the buyer. I.R.C. § 164(d)(1)(B).

c. Rules when one party pays the tax obligation of the other.

(1) If the buyer pays the seller's share of tax, the amount is included in the cost basis of the property. I.R.C. § 164(a) (flush language).

(2) If the seller pays the buyer's portion, the amount is deducted from the seller's amount realized (sales price) for the sale. I.R.C. § 164(a) (flush language).

(3) Neither buyer nor seller may claim any deduction for the portion of the tax obligation owed by the other. I.R.C. § 164(c)(2).

4. Military and parsonage housing allowance exception. Under I.R.C. § 265(a)(6), receipt of a parsonage housing allowance or a military housing allowance does

not disqualify deductions for mortgage interest or real property tax on the taxpayer's home.

F. Personal property taxes. I.R.C. § 164(a)(2).

1. A "personal property tax" is [I.R.C. § 164(b)(1); Treas. Reg. § 1.164-3(c)]:

a. Imposed on personal property.

b. Based on the value of that property (*ad valorem*); and

c. Assessed on an annual basis.

2. A personal property tax may be deductible only in part if, for example, a portion of the stated tax constitutes a registration or similar fee and only the remainder is assessed upon the value of the property. Treas. Reg. § 1.164-3(c)(3) ("For example, in the case of a motor vehicle tax of 1 percent of value plus 40 cents per hundredweight, the part of the tax equal to 1 percent of value qualifies as an ad valorem tax and the balance does not qualify.").

G. State, local, and foreign income taxes. I.R.C. § 164(a)(3).

1. Deduction of state and local income tax is normally straightforward. The taxpayer deducts the amount of such taxes withheld for the year, as shown on his or her Form W-2, as well as any other payments during the year. Other payments include payments with the prior-year return and estimated payments made during the calendar year

2. Note: For treatment of state tax refunds as potential income items, see Chapter B.

H. The following are <u>not</u> deductible taxes:

1. Federal income taxes, Social Security, Medicare, and unemployment taxes. I.R.C. § 275(a)(1).

2. Inheritance and gift taxes. I.R.C. § 275(a)(3).

3. Motor vehicle registration and inspection fees.

4. Per capita or poll taxes.

5. Tobacco or liquor taxes.

6. Excise taxes on gasoline or motor fuels.

7. Fees or charges such as: drivers' licenses, tolls, hunting licenses, and homeowners' association dues.

VI. INTEREST

A. References: I.R.C. § 163(a) & (h); Pub. 530; Pub. 936.

B. Section 163(a) provides that interest paid during the taxable year is deductible; however, Section 163(h)(1) then provides that all "personal interest" is non-deductible. Section (h)(2)(A)-(F) excludes from the definition of "personal interest" certain well-known personal interest deductions that are allowed, including qualified residence (home mortgage) interest, investment interest, and passive activity interest. I.R.C. § 162(h)(2)(A)-(D).

C. General rules.

1. Normally, only the individual liable for the loan in question may deduct any interest associated with it. *Brown v. Comm'r*, 1 T.C. 225, 227 ("[I]t is well settled that the payment must be that of interest on the obligation of the taxpayer claiming the deduction. Payments of interest on the obligations of others do not meet the statutory requirements.").

a. However, as noted above in *Trans v. Comm'r*, T.C. Memo. 1999-233, a taxpayer may establish in narrow circumstances that he or she is the equitable owner of property and therefore entitled to mortgage interest and real estate taxes deduction. Treas. Reg. § 1.163-1(b) ("Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness."); *see also Uslu v. Comm'r*, T.C. Memo. 1997-551, at *10-12 (holding that taxpayers entitled to mortgage interest deduction as equitable and beneficial owners of the property.

2. Prepaid interest by a cash-basis taxpayer (i.e., almost everyone) is deductible only in the future periods to which the interest relates. I.R.C. § 461(g)(1).

D. Qualified residence interest. I.R.C. § 163(h)(3).

1. For tax years after 1987, qualified residence interest means interest paid on "acquisition indebtedness" or "home equity indebtedness" on a "qualified residence."

a. "Acquisition indebtedness" is a debt used to acquire, construct, or substantially improve a home provided the debt is secured by a qualified residence. I.R.C. § 163(h)(3)(B).

b. "Qualified residence" includes the taxpayer's principal residence (same definition as I.R.C. § 121) and one other home. I.R.C. §§ 280A(d)(1), 163(h)(4).

c. Acquisition indebtedness incurred before 15 December 2017 may not exceed $1,000,000 ($500,000 for a married person filing a separate return). I.R.C. § 163(h)(3)(B).

(1) Indebtedness incurred before October 13, 1987 is not subject to the $1,000,000 acquisition debt limit.

d. A refinancing is treated the same as original acquisition debt, but only up to the principal amount of the acquisition debt outstanding immediately before the refinancing. I.R.C. § 163(h)(3)(F)(iii).

e. Acquisition indebtedness incurred after 15 December 2017 is limited to $750,000 for years 2018 through 2025. I.R.C. § 163(h)(3)(F).

(1) Loans on or before 15 December 2017 are grandfathered (i.e., the $1,000,000 limit still applies).

(2) Refinancing is also grandfathered as long as the new principal amount does not exceed the old amount.

f. If the original acquisition debt is paid off, further borrowing may qualify as acquisition debt if the funds are used to improve the home. If no

acquisition indebtedness is outstanding, interest on home equity indebtedness is deductible, subject to the limits stated below.

2. "Home equity indebtedness" is any indebtedness secured by a qualified residence to the extent of the lesser of (*i*) the fair market value of the house or (*ii*) $100,000 ($50,000 for married individual filing separately). I.R.C. § 163(h)(3)(C).

   a. Before 2018, home equity interest was deductible up to these limits even if the loan was used for personal purposes.

   b. Beginning in 2018, home equity interest is deductible only if used to buy, build, or improve the taxpayer's main residence. I.R.C. § 163(h)(3)(F)(i)(I).

3. Military and parsonage housing allowance exception. Under I.R.C. § 265(a)(6), receipt of a parsonage housing allowance or a military housing allowance does not disqualify the taxpayer from deducting mortgage interest or real property tax on the taxpayer's home.

E. Points.

1. Points are charges paid by a borrower to obtain a home mortgage. They also may be called loan origination fees, maximum loan charges, loan discount, or discount points. Pub. 936 (Points). They are typically paid upfront at closing and calculated as a percentage of the loan amount.

2. Points represent interest if they are "solely for use of or forbearance of money" and not a charge of money for services. *Cao v. Comm'r*, T.C. Memo. 1994-60, 67 T.C.M. (CCH) 2171, 2173 (citing *Deputy v. Du Pont* , 308 U.S. 488, 498 (1940) and *Goodwin v. Commissioner* 75 T.C. 424, 440-441 (1980)).

3. As noted above, prepaid interest is generally non-deductible until the periods to which they relate arise. I.R.C. § 461(g)(2) provides a limited exception to this rule for points paid to purchase or improve the taxpayer's principal residence, where payment of points is an established business practice where the debt was incurred and the amount paid does not exceed the amount generally charged in the area. The Treasury Regulations contemplated by the statutory language of Section 461(g)(2) have never been issued.

4. Under Rev. Proc. 94-27, however, the IRS established administrative guidance under which it would not contest a current deduction for points paid by a cash-basis taxpayer (almost everyone) in certain specific circumstances. This guidance is incorporated into Pubs. 936 and 17. The requirements are as follows:

   a. The settlement statement clearly designates the points payable in connection with the loan.

   b. The points are computed as a percentage of the amount borrowed.

   c. The points paid conform to an established business practice of charging points in the area where the residence is located and do not exceed the amount generally charged in that area.

      (1) If an amount designated as points is paid in lieu of costs ordinarily stated separately (e.g., appraisal fees, inspection fees, title fees, attorney fees, and property taxes), the amount does not represent deductible points.

   d. The points are paid in connection with the acquisition (improvements do not qualify, but see below) of the taxpayer's principal residence, and the loan is secured by that residence.

   e. The points do not exceed amounts paid by the taxpayer (and not borrowed for this purpose) at closing in the form of a downpayment, escrow deposit, earnest money, or otherwise.

      (1) Seller-paid points are deemed as paid by the taxpayer if he or she reduces the basis in the home by that amount.

      (2) Note: the seller does not deduct these points, but reduces the amount realized from the sale (the purchase price) by the amount of points paid.

5. Home improvement loans.

   a. Although Rev. Proc. 94-27 by its terms does not apply to refinancings or home improvement loans, the language of Section 461(g)(2) expressly

references the "purchase or improvement" of the taxpayer's principal residence.

b. In published guidance, the IRS states that cash-basis taxpayers "can also fully deduct in the year paid points paid on a loan to substantially improve" his or her principal residence. Pub. 936 (Home Mortgage Interest – Points) where a subset of the Rev. Proc. 94-27 tests are met. The requirements in Pub. 936 are as follows:

(1) The loan is secured by the principal residence.

(2) Paying points is an established practice and the amount paid is not more than that generally charged in the area.

(3) The points were not paid in lieu of amounts that are normally stated separately on the settlement statement.

(4) Funds provided at closing were at least equal to the points charged.

6. Refinancing.

a. The refinance of a loan typically will not qualify a taxpayer for a current deduction of points paid.

b. However, a refinancing where a portion of the proceeds are used to substantially improve the loan is treated as a home improvement loan above. Rev. Rul. 87-22 (Situation 2).

7. Points paid on debt related to a second home or vacation home will not qualify for the above safe harbor and must be deducted ratably over the life of the loan.

8. Where the taxpayer does not qualify to deduct points in full, he or she must amortize them over the period of the loan. Under Rev. Proc. 87-15, the cash-basis taxpayer qualifies for a ratable deduction of points secured by a residence (whether or not it is the taxpayer's residence) in the following circumstances:

a. The principal amount of the loan is $250,000 or less;

b. The loan term is no greater than 30 years;

c. If the loan is greater than 10 years, the terms are customary in the area for similar loans of the same or longer duration; and

d. The loan principal is either:

(1) $250,000 or less; *or*

(2) If the loan has a term of 15 years or less, no more than 4 points are charged; *and*

(3) If the loan term is greater than 15 years, nor more than 6 points are charged.

F. Mortgage insurance premiums treated as home mortgage interest.

1. This is a so-called "tax extender" or temporary provision that is periodically renewed by Congress.

2. Premiums paid or accrued for "qualified mortgage insurance" are deductible as home mortgage interest if the mortgage insurance contract was issued after 2006. I.R.C. § 163(h)(3)(E)(i), (iii).

3. Phaseout. The amount deductible is reduced by 10% for every $1,000 ($500 if the filing status is married filing separately) by which AGI exceeds a statutory amount of $100,000 ($50,000 for married filing separately). I.R.C. § 163(h)(3)(E)(ii). Therefore, the deduction is fully phased out for AGI exceeding $109,000.

4. Qualified mortgage insurance.

a. This is mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (as defined in § 2 of the Homeowners Protection Act of 1998 as in effect on December 20, 2006).

b. If premiums paid for qualified mortgage insurance are properly allocable to periods after the close of the taxable year, the premiums are treated as paid in the year to which they relate. No deduction is allowed for the unamortized balance if the mortgage is satisfied before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration).

G. Investment interest. I.R.C. § 163(d); Pub. 550.

1. Investment interest is interest paid to purchase or carry property held for investment. I.R.C. § 163(d)(3)(A).

2. The term "investment interest" does not include [I.R.C. § 163(d)(3)(B)]:

a. Any "qualified residence" interest, or

b. Passive activity interest.

3. Investments are capital assets like stocks, bonds, securities, and other capital investment assets other than a principal residence.

4. A deduction for investment interest is limited to the amount of net investment income. Net investment income is the excess of investment income over investment expenses and is calculated on Form 4952. Disallowed investment interest deductions can be carried forward to succeeding tax years to be applied against future investment income. I.R.C. § 163(d)(2).

5. The interest must not be used to produce tax-exempt income. I.R.C. § 265(a)(1).

VII. CHARITABLE CONTRIBUTIONS

A. References: I.R.C. § 170; Treas. Reg. § 1.170A-1 – 1.170A-17; Pub. 526; Form 8283.

B. General requirements for charitable deduction:

1. The gift must be to a qualified organization. I.R.C. § 170(c).

a. The taxpayer may deduct contributions to domestic religious, charitable, educational, scientific, literary, or educational organizations. I.R.C. § 170(c)(2).

(1) Examples include churches, nonprofit hospitals, colleges, museums, American Red Cross, United Way, Boy Scouts of America, Girl Scouts of America, nonprofit volunteer fire companies, and nonprofit organizations that develop parks and recreation facilities.

b. The IRS maintains a non-exhaustive list of qualified organizations online (Tax Exempt Organization Search, https://apps.irs.gov/app/eos/).

c. Note: I.R.C. § 6113 prohibits noncharitable fund-raising groups from soliciting, unless they warn taxpayers targeted that donations are nondeductible.

2. The contribution must be made in the tax year. I.R.C. § 170(a)(1).

a. If a mailed check clears in due course (or a properly endorsed stock certificate is received), the contribution is deemed made upon date of mailing. Treas. Reg. § 1.170A-1(b).

b. A charge to a credit card is deductible when the charge is made, regardless of when the bank is repaid. Rev. Rul. 78-38, 1978-1 C.B. 67; *see also Granan v. Comm'r*, 55 T.C. 753, 755-56 (1971) (concluding that medical expenses were paid upon delivery of promissory note).

3. The taxpayer must reduce the deduction by the value of any benefit received, e.g., the value of attending a social or dinner event. Treas. Reg. § 1.170A-1(b)(2).

C. Generally, taxpayers may deduct the following:

1. Contributions of cash and property to or for the use of a qualified organization. I.R.C. § 170(c).

2. The fair market value of property contributed. Treas. Reg. § 1.170A-1(c).

a. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and each having reasonable knowledge of relevant facts. Treas. Reg. § 1.170A-1(c)(2).

3. Out-of-pocket expenses paid incident to the rendition of services to a charitable organization. Treas. Reg. § 1.170A-1(g); Rev. Rul. 69-473; Rev. Rul. 84-61.

a. The mileage rate for purposes of the deduction is a statutory amount of 14 cents per mile (not adjusted for inflation). I.R.C. § 170(i).

D. Limits on Charitable Deductions.

1. Amount of the contribution. As noted, the deduction is normally in the amount of the cash or fair market value of property contributed, less the value of any benefit received. For property contributions, the following additional rules apply:

a. If the fair market value is less than the taxpayer's basis, the contribution is limited to fair market value (and the difference is not a deductible loss).

b. For ordinary income property, such as inventory or capital assets held for one year or less, the donation amount must be reduced by any appreciation. This normally means that the deduction will equal the taxpayer's basis in the property.

c. Note. The taxpayer ordinarily claims a deduction for a donation of capital gain property at its fair market value. In most circumstances, no reduction for appreciation is required.

2. Clothing or household items

a. Generally, the items contributed must be in "good used condition or better." I.R.C. § 170(f)(16)(A).

b. The deduction may be denied for contribution of clothing or household items of minimal monetary value (i.e., sock and undergarments). I.R.C. § 170(f)(16)(B).

c. The limitations of Section 170(f)(16)(A)-(B) do not apply where a single item is valued at over $500 pursuant to a qualified appraisal, which must be attached to the taxpayer's return.

3. The contribution amount must be less than the applicable AGI percentage limitations. I.R.C. § 170(b).

a. 60% of AGI for cash contributions to most charities (public charities and private operating foundations as well as other non-operating foundations) for years 2018 through 2025. After 2025, the 60% limit reverts to 50%. These are referred to below as "50% organizations."

b. 50% of AGI for non-cash contributions to 50% organizations, as well as for both cash and non-cash contributions before 2018 or after 2025.

c. 30% of AGI for organizations that do not qualify as 50% charities. These include veterans' organizations, fraternal societies, non-profit cemeteries, and certain private foundations. (Check the IRS Tax-Exempt Organization search.) The 30% limit also applies to gifts of capital gain property to 50% organizations, as well as certain gifts "for the use" of a charitable organization (e.g., an income interest in trust property).

d. 20% of AGI for capital gain property contributed to a non-50% organization.

e. Amounts in excess of the percentage limits are carried forward for up to five years. I.R.C. § 170(d)(1).

E. The following is a non-exhaustive list of items that are <u>not</u> deductible as charitable contributions [Pub. 526 – Contributions You Can't Deduct]:

1. A contribution to a specific individual;

2. The portion of a contribution representing a benefit to the taxpayer;

3. The value of the taxpayer's time or services; and

4. Appraisal fees.

F. Recordkeeping. A taxpayer must maintain records substantiating any charitable contribution claimed for the year. Failure to adhere to these substantiation disqualifies the deduction. *See, e.g.*, *Durden v. Comm'r*, T.C. Memo. 2012-140, at *5-10 (rejecting taxpayer's position that substantial compliance with substantiation rules was sufficient to claim the deduction).

1. General Requirements – Cash Contributions. A taxpayer cannot deduct any cash contribution, regardless of amount, unless he or she keeps at least one of the following:

a. A bank record, including a statement from a financial institution, an electronic fund receipt, a canceled check, a scanned image of both sides of a canceled check from a bank website, or a credit card statement showing the name of the donee and the date and amount of the contribution. Treas. Reg. § 1.170A-15(a)(1), (b)(2).

b. A written communication, including an email, showing the name of the donee and the date and amount of the contribution. Treas. Reg. § 1.170A-15(a)(1), (b)(3).

2. General Requirements – Non-cash Contributions. A taxpayer cannot deduct any cash contribution, regardless of amount, unless he or she keeps at least one of the following:

a. The taxpayer must obtain a receipt that shows [Treas. Reg. §§ 1.170A-13(b)(1)(i)-(iii), 170A-16(a)(1)(i)-(iii)]:

(1) The name of the organization;

(2) The date of the contribution; and

(3) A sufficiently detailed description of the property to ascertain that the described property is the contributed property.

b. Where impractical to obtain a receipt (e.g., use of drop-off site), the taxpayer may substitute "other reliable written records."

(1) Reliability is determined by the facts and circumstances, including the proximity in time of the written record to the contribution. Treas. Reg. § 1.170A-16(a)(2)(i). In addition to

contemporaneity, other relevant circumstances include the regularity of the taxpayer's recordkeeping procedures and the existence of documentation from the charity (even if that documentation does not qualify as a receipt under the substantiation rules). Treas. Reg. § 1.170A-13(a)(2)(i)(A)-(C).

(2) Other reliable written records must include the following [Treas. Reg. § 1.170A-16(a)(2)(iii)]:

(a) The requirements for a receipt above, i.e., state the name of the donee organization and the date and amount of the contribution [Treas. Reg. § 1.170A-16(a)(2)(ii)];

(b) Fair market value of the property on the date of contribution;

(c) Method used in determining fair market value; and

(d) If a clothing or household item, the condition of the item.

3. Contributions for $250 or more. For any contribution at least equal to $250, the taxpayer must obtain a "contemporaneous written acknowledgement" from the charitable organization.

a. The above substantiation requirements for cash or non-cash contributions apply, but "reliable written records" no longer suffice. The taxpayer must have a bank record or written receipt for the contribution.

b. In addition, the taxpayer must obtain a "contemporaneous written acknowledgment" satisfying the statutory requirements.

(1) An acknowledgment is "contemporaneous" if obtained before the earlier of (1) the day the return is filed or (2) the return is due (including extensions). I.R.C. § 170(f)(8)(C); Treas. Reg. §1.170A-13(f)(3).

(2) The written acknowledgment must include the following [I.R.C. § 170(f)(8)(B)(i)-(iii)]:

(a) The amount of cash or a description (but not value) of the property contributed.

(b) Whether the donee provided any goods or services in consideration, in whole or part, for any property described in the acknowledgment.

(c) A description and good faith estimate of the value of any goods or services provided to the donor.

(i) Intangible religious benefits do not need to be valued, but the acknowledgment must state if the benefits provided to the taxpayer consist solely of the same. I.R.C. § 170(f)(8)(B)(iii); Treas. Reg. § 1.170A-13(f)(2)(iii).

(3) Note that the requirements for a written receipt and a written acknowledgment differ. In practice, organizations normally provide one document satisfying all pertinent substantiation requirements. Treas. Reg. § 1.170A-15(a)(3) (allowing one document to satisfy the requirements of both I.R.C. § 170(f)(8) and (f)(17)). This principally requires the written acknowledgment for a gift of $250 or more to include the date of the contribution and name of the organization.

4. Non-cash contributions of property for $250 or more, but not more than $500.

a. Non-Aggregation for $250 threshold. For purposes of the $250 threshold only, multiple donations are not aggregated. Treas. Reg. §1.170A-16(f)(5)(i). For example, three visits to a drop-off site with donations of $100 each do not trigger the substantiation requirements for contributions of $250 or more.

b. Non-cash contributions require the taxpayer only to obtain the contemporaneous written acknowledgement described above. Treas. Reg. § 1.170A-16(b).

5. Non-cash contributions of property of more than $500 but not more than $5,000.

   a. Multiple donations must be aggregated for the $500 and greater thresholds. I.R.C. § 170(f)(11)(F); Treas. Reg. § 1.170A-16(f)(5)(ii).

   b. The taxpayer must file Form 8283 (Section A) and include the additional information required by the form, such as the manner of acquisition of the property, its cost basis, and whether the donee has certified it for use in the organization's purpose. Treas. Reg. § 1.170A-16(c)(3).

6. Non-cash contributions of property exceeding $5,000. The taxpayer must meet all above requirements, as well as file Form 8283 (Section B) and obtain a qualified appraisal. Treas. Reg. § 1.170A-16(d).

G. Vehicle Donations.

1. References: I.R.C. § 170(f)(12); I.R.S. Notice 2005-44, 2005-25 I.R.B. 1287 ("Notice 2005-44"); I.R.S. Notice 2006-1, 2006-4 I.R.B. 347; I.R.S. Notice 2007-70, 2007-40 I.R.B. 735.

2. General rule. If the charitable organization sells a donated vehicle with a claimed value of more than $500 without any significant intervening use or material improvement of the vehicle (which is very common), the taxpayer's deduction for a car donation is limited to the actual sales prices of the vehicle when sold by the donee charity. I.R.C. § 170(f)(12)(A)(ii).

   a. A vehicle with a claimed value from $250 up to $500 only requires the contemporaneous written acknowledgment for non-cash contributions discussed above. Notice 2005-44, § 4.01.

   b. If the vehicle is sold for $500 or less, the deduction amount equals the lesser of $500 or the fair market value on the date of contribution. Notice 2005-44, § 4.02.

   c. Fair market value. The IRS permits the fair market value to be determined by reference to an established used vehicle pricing guide, provided the guide lists a sales price that (*i*) is the same make, model, and year, (*ii*) is sold in the same area, (*iii*) is in the same condition, (*iii*) has the same or substantially similar options or accessories, and

(*iv*) includes the same or substantially similar warranties or guarantees. Rev. Rul. 2002-67, 2002-47 I.R.B. 873.

3. The taxpayer must receive a contemporaneous written acknowledgment containing more stringent requirements than those required for other contributions of property, as discussed above.

   a. The taxpayer must file the acknowledgment with his or her tax return. IRS Form 1098-C, which the organization must file with the IRS and must send to the taxpayer, satisfies this requirement and therefore should be used.

   b. The required acknowledgment (Form 1098-C) must include the following [I.R.C. § 170(f)(12)(B)]:

      (1) Name and taxpayer identification number of the donor.

      (2) Vehicle identification number.

      (3) If sold without significant intervening use or material improvement:

         (a) Certification that the vehicle was sold in an arm's length transaction between unrelated parties;

         (b) Gross sales proceeds; and

         (c) Statement that the amount deductible may not exceed the gross proceeds.

      (4) If not sold in the above circumstances:

         (a) Certification of intended use or material improvement, whichever applies, and the intended duration of such use;

         (b) Certification that the vehicle would not be transferred in exchange for money, property, or services before completion of such use or improvement;

(c) Whether the donee organization provided any goods or services in consideration for the qualified vehicle; and

(d) If so, a description and good faith estimate of the value of any goods or services provided (or, if applicable, a statement that only intangible religious benefits were provided).

4. The deduction is not limited to the sales price if in the following circumstances below. The charity must document this use on Form 1098-C or equivalent. Notice 2005-44, §§ 3.02, 7.02.

a. The charity makes a significant intervening use of the vehicle. Notice 2005-44, § 3.02(2).

b. The charity makes a material improvement to the vehicle, i.e., major repairs that significantly increase its value. Notice 2005-44, § 3.02(3).

c. The charity donates or sells the vehicle to a needy individual at a significantly below-market price, provided the transfer furthers the charitable purpose of helping a poor person in need of a means of transportation. Notice 2005-44, § 3.02(4).

5. Vehicles include automobiles designed for street use, as well as boats or airplanes. I.R.C. § 170(f)(12)(E).

VIII. CASUALTY AND THEFT LOSSES

A. References: I.R.C. § 165; Treas. Reg. §§ 1.165-7, 1.165-8; Pub. 547; Form 4684.

B. General rule. A taxpayer may deduct a personal casualty loss sustained during the year as an itemized deduction, subject to AGI and per-event limitations. I.R.C. § 165(a), (h); Treas. Reg. § 1.165-1(b).

1. A personal casualty loss is a loss of property "not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft." I.R.C. § 165(c)(3).

2. This means damage, destruction, or loss of property from identifiable events that are sudden, unexpected, or unusual. *See, e.g., Matheson v. Comm'r*, 54 F.2d 537, 539 (2d Cir. 1931); Treas. Reg. 1.165-1(b).

3. Amount of deduction.

a. The loss is reduced by $100 per casualty event. I.R.C. § 165(h)(1).

b. The deduction is allowed only for the net portion of losses that exceeds 10% of AGI. I.R.C. § 165(h)(2).

(1) A taxpayer may realize a casualty gain as well as loss, where, e.g., insurance proceeds exceed the taxpayer's basis in the property. Gains and losses for the year are netted.

(2) If the net result is a gain, the gains and losses are treated as if they occurred from the sale of capital assets. I.R.C. § 165(h)(2)(B).

C. For tax years 2018 through 2025, personal casualty and theft losses are deductible only if attributable to "Federally declared disaster."

1. A "Federally declared disaster" is a disaster "subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act [42 U.S.C. § 5121 *et seq.*]." I.R.C. § 165(h)(5)(A), (i)(5).

2. The $100 and 10% limitations still apply.

3. The taxpayer may continue to offset casualty gains with previously deductible losses. I.R.C. § 165(h)(5).

4. Because disasters are declared on a state-wide basis, the loss must occur within a state receiving a federal disaster declaration. I.R.S. Program Manager Technical Advice 2009-008, https://www.irs.gov/pub/lanoa/pmta-2019-08.pdf; Pub. 547 (Casualty) (see definition of "Federal casualty loss").

D. Examples of casualty events. See Rev. Rul. 76-134, 1976-1 C.B. 54; Pub. 547 (Casualty).

1. Examples of qualifying events. Car accidents (if not due to taxpayer's willfulness or negligence), storms, earthquakes, fires, vandalism.

2. Examples of non-qualifying events. Car accidents involving taxpayer willfulness or negligence, deterioration from normal processes (wear and tear), termite and moth damage, fungus or disease.

E. Definition of Theft.

1. Taking and removing of money or property with the intent to deprive the owner of it, e.g., larceny, embezzlement, and robbery. Treas. Reg. § 1.165-8. This requires:

a. That the taking or removal was illegal; and

b. The perpetrator acted with criminal intent. Rev. Rul. 72-112, 1972-1 C.B. 60; Pub. 547.

2. Special rules apply to theft losses arising from Ponzi-type investments schemes. *See* Rev. Rul. 2009-9, 2009-14 I.R.B. 735; Rev. Proc. 2009-20, 2009-14 I.R.B. 749; Rev. Proc. 2011-58, 2011-50, I.R.B. 847.

F. Timing of deduction.

1. A casualty loss deduction is claimed for the year in which the loss is sustained, as evidenced by closed and completed transactions and as fixed by identifiable events occurring within the tax year. Treas. Reg. § 1.165-1(d)(1). See below for an exception available at the election of the taxpayer for federally declared disaster areas.

2. A theft deduction is claimed for the year in which the taxpayer discovers the loss. I.R.C. § 165(e); Treas. Reg. § 1.165(d)(3).

G. Amount of deduction.

1. The amount of loss is the lesser of (1) the decrease in fair market value (FMV) of the property or (2) the adjusted basis of the property. Treas. Reg. § 1.165-7(b).

   a. Sentimental value is disregarded. *Ganas v. Comm'r*, T.C. Memo. 1990-143, 59 T.C.M. (CCH) 151, 156 (1990).

   b. A general decline in fair market value based on the occurrence of a casualty nearby, but with no damage to the taxpayer's property, is not deductible. *Pulvers v. Comm'r*, 407 F.2d 838 (9th Cir. 1969).

2. The fair market value of the property generally must be determined by competent appraisal immediately before and immediately after the casualty. Treas. Reg. § 1.165-7(a)(2)(i).

3. Cost of repairs is generally permissible to estimate the decrease in fair market value, as long as the repairs [Treas. Reg. § 1.165-7(a)(2)(ii)]:

   a. Are necessary for the restoration of property;

   b. Are not excessive in amount;

   c. Do not extend beyond the damage suffered;

   d. Do not increase the value of the property; and

   e. Were actually performed.

      (1) In other words, there is no deduction allowed for estimated future repairs. *Lamphere v. Comm'r*, 70 T.C. 391, 396 (1978).

4. Because of the difficulty in estimating fair market value, the IRS has prescribed safe harbor estimation methods for personal use residential real property and personal belongings, based on the type of property and the amount of loss. *See generally* Rev. Proc. 2018-08, 2018-2 I.R.B. 286; Pub. 547 (Figuring a Loss –

Decrease in Fair Market Value – Special Procedure—Safe Harbor Methods for Determining Casualty and Theft Losses).

H. Insurance. I.R.C. § 165(h).

1. If covered by insurance, a claim must be filed. I.R.C. § 165(h)(4)(E).

2. The deduction must be reduced by the amount of the insurance or other compensation. I.R.C. § 165(a); Treas. Reg. § 1.165-1(c)(4).

I. Losses in federally declared disaster areas.

1. References: I.R.C. § 165(i); Temp. Treas. Reg. § 1.165-11T; Rev. Proc. 2016-53, 2016-44 I.R.B. 530.

2. Note. To qualify for the special provisions of I.R.C. § 165(i), such as claiming the loss for the preceding year (see below), the loss must occur within an area qualifying for federal assistance. I.R.C. § 165(i)(5)(B). This is narrower than a loss that is "attributable to a Federally declared disaster," as that phrase is used for years 2018 through 2025.

3. If the taxpayer sustains an allowable casualty loss in an area eligible for assistance as the result of a "federally declared disaster," the taxpayer may elect to deduct the loss in the immediately preceding year to the year of the disaster. I.R.C. § 165(i)(1); Temp. Treas. Reg. § 1.165-11T(a).

a. A "federally declared disaster" is one determined by the President of the United States to warrant assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act ("Stafford Act"), 42 U.S.C. § 5121 et seq. (the primary statutory authority for FEMA emergency response programs). I.R.C. § 165(i)(4)(A); Temp. Treas. Reg. § 1.165-11T(b)(1).

b. The due date for the election is six months from the due date of the original return, without regard to filing extensions. Temp. Treas. Reg. § 1.165-11T(f).

c. The election may be revoked within 90 days after the due date for making the election. Temp. Treas. Reg. § 1.165-11T(g).

d. If the taxpayer has already filed a tax return claiming the loss and wants to make an election to use the other allowable year, the taxpayer first must file an amended return to remove the originally claimed loss. In other words, the taxpayer must not have two tax returns on file with the IRS claiming the same deduction for different years. Temp. Treas. Reg. § 1.165-11T(d); Rev. Proc. 2016-53, § 4.01-03.

4. Congress frequently enacts special casualty loss provisions for particular disasters.

a. These provisions typically increase the $100 threshold amount, remove the 10% floor, and allow the taxpayer to deduct losses even if he or she claims the standard deduction. *See, e.g.*, Bipartisan Budget Act of 2018, Pub. L. No. 115-123, § 20104 (California wildfires); TCJA, § 11028 (Dec. 22, 2017) (2016 disaster areas); Disaster Relief and Airport and Airway Extension Act of 2017, Pub. L. No. 115-63, 131 Stat. 1168, § 504(b) (Sept. 29, 2017) (Hurricanes Harvey, Irma, and Maria in 2017).

b. The IRS may prescribe special methods to value losses from such casualties. *See, e.g.*, Rev. Proc. 2018-9, 2018-2 I.R.B. 290.

IX. MISCELLENEOUS ITEMIZED DEDUCTIONS

A. References: I.R.C. §§ 63, 67; Treas. Reg. § 1.67-1T; Pub. 529.

B. For years 2018 through 2025, the deductions for job-related and other miscellaneous itemized deductions subject to the 2% AGI floor were suspended. I.R.C. § 67(a). Therefore, the topic has been removed from this outline.

X. CONCLUSION

CHAPTER E

TAX CREDITS

TABLE OF CONTENTS

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

I. REFERENCES

A. Internal Revenue Code of 1986, §§ 21-37.

B. Federal Income Tax Regulations (Treas. Reg.)

C. IRS Publications:

1. Pub. 17, Your Federal Income Tax

2. Pub. 503, Child and Dependent Care Expenses

3. Pub. 524, Credit for the Elderly or Disabled

4. Pub. 596, Earned Income Credit

5. Pub. 970, Tax Benefits for Education

6. Pub. 972, Child Tax Credit

D. IRS Forms and Instructions: W-2, 1098-T, 1040, 1040 (Schedule R), 1040 (Schedule 8812), 2441, 8839, 8910, 8936, 8880, 5695, 5405, 8863.

II. INTRODUCTION

A. Taxpayers, whether or not in business, may qualify for one or more personal credits. A tax credit is a dollar-for-dollar reduction of the taxpayer's tax liability.

B. A refundable credit can be greater than the tax owed. Taxpayers not only can have their tax reduced to zero, but they can also receive a refund of the excess credit. A refundable credit is treated as an amount paid to the IRS and owed to the taxpayer if his or her tax liability is less than the deemed payment.

C. A nonrefundable credit can also be greater than the tax, but the nonrefundable credit can only reduce tax liabilities to zero. Taxpayers do not receive a refund for any excess nonrefundable credit.

III. CHILD AND DEPENDENT CARE CREDIT

A. References: I.R.C. § 21; Treas. Reg. §§ 1.21-1 – 1.21-4; Pub. 503; Form 2441.

B. A nonrefundable credit is allowed for a portion of qualifying child or dependent care expenses paid for the purpose of allowing a taxpayer (and the taxpayer's spouse, if married filing jointly) to be gainfully employed. I.R.C. § 21(a)(1), (b)(2).

C. Qualifying Person. To be eligible for the credit, the taxpayer must pay for the care of a qualifying individual, which includes:

1. A dependents under age 13 who is a qualifying child under I.R.C. § 152(a)(1). I.R.C. § 21(b)(1)(A).

2. A dependent as defined under I.R.C. § 152, determined without regard to I.R.C. § 152(b)(1), (b)(2), and (d)(1)(B), who is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year. I.R.C. § 21(b)(1)(B).

a. In other words, the following dependent tests are relaxed for these purposes: (1) dependent-of-another [I.R.C. § 152(b)(1)]; (2) joint return [I.R.C. § 152(b)(2)]; and (3) gross income [I.R.C. § 152(d)(1)(B)]. See Chapter A.

3. A spouse who is physically or mentally unable to care for self and has the same principal place of abode as the taxpayer for one-half of the tax year. I.R.C. § 21(b)(1)(C).

4. Note. In the case of a dependent child under the age of 13 where the parents are divorced or legally separated and lived apart during the last 6 months of the year, only the custodial parent can claim the child and dependent care credit. This is so even if the custodial parent does not claim that child as a dependent. I.R.C. § 21(e)(5).

D. Gainful Employment. Treas. Reg. § 1.21-1(c)(1).

1. Expenses must be employment-related, enabling the taxpayer to be gainfully employed or in the active search for gainful employment.

2. The expense is not employment-related just because it is paid or incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed.

3. A taxpayer's spouse is deemed to be gainfully employed during each month that he or she is a full-time student at an educational institution or some part of each of five calendar months during the tax year. I.R.C. § 152(d)(2).

4. Volunteer work, even if for nominal consideration, is never gainful employment.

5. Gainful employment can be self-employment and can be done in the home of the taxpayer.

6. Part-time work. Treas. Reg. § 1.21-1(c)(2)(iii).

   a. If the taxpayer works only part time, the taxpayer must allocate expenses for dependent care between the days of work and the days not worked.

   b. A day where the taxpayer works at least one hour is a day of work.

   c. If the taxpayer must pay dependent care expenses on a periodic basis including both workdays and non-workdays, there is no requirement to allocate.

7. Qualifying expenses include:

   a. Expenses paid for household services and for the care of a qualifying individual. I.R.C. § 21(b)(2)(A)(i)-(ii).

      (1) Household services are performance in the home of ordinary and usual services necessary to the maintenance of the household and attributable to the care of the qualifying individual. Treas. Reg. § 1.21-1(d)(3).

      (2) Amounts paid for food, lodging, clothing, and education do not qualify for the credit. Treas. Reg. § 1.21-1(d)(1).

   b. Services outside the home. These qualify if for the care of a qualified child, disabled spouse, or dependent who regularly spends at least eight hours a day in the taxpayer's home. I.R.C. § 21(b)(2)(B).

      (1) Dependent care centers. The center must comply with applicable state and local laws and provide care in exchange for a fee for more than six individuals. I.R.C. § 21(b)(2)(C)-(D).

(2) Pre-school, nursery school and similar programs generally qualify. Treas. Reg. § 1.21-1(d)(7).

(3) Day-camp fees generally qualify. Treas. Reg. § 1.21-1(d)(7). However, tutoring and summer school expenses are not qualifying expenses because they are not employment-related. Treas. Reg. § 1.21-1(d)(7)(i).

(4) Before- and after-school programs qualify. Treas. Reg. § 1.21-1(d)(5).

(5) Costs of transportation paid by a dependent care provider qualify if paid to transport the recipient to or from the place where care is provided. Treas. Reg. § 1.21-1(d)(8).

(6) Indirect expenses required to obtain care, such as au pair agency fees, generally qualify. Treas. Reg. § 1.21-1(d)(11), (d)(12) Ex. 5. Forfeited deposits or other expenses where care is not provided do not qualify. *Id.* & Ex. 8.

(7) Expenses for overnight camps are disallowed. I.R.C. § 21(b)(2)(A) (flush language).

E. Amount of credit. The credit is based on a percentage ranging from 20% to 35% of the lesser of (*i*) actual expenses; or (*ii*) $3,000 for one qualifying child or dependent, or $6,000 for two or more qualifying children or dependents. I.R.C. § 21(c).

1. The percentage amounts corresponding to the earned income of the taxpayer are set forth on Form 2441.

F. Limitations.

1. Work-related expenses are reduced by any tax-free reimbursements under a qualified employer dependent care

program, which will be noted on Form W-2. I.R.C. §§ 21(c) (flush language), 129.

2. Qualifying employment-related expenses are considered in determining the credit only to the extent of earned income (wages, salary, etc.). I.R.C. § 21(d).

3. For married taxpayers, both normally must work to claim the credit. For married taxpayers, expenses are limited to the earned income of the lower earning spouse. I.R.C. § 21(d)(1)(B).

4. However, if a non-working spouse is physically or mentally incapable of caring for himself or is a full-time student at an educational organization for at least five calendar months during the year, earned income for each month of disability or school attendance is deemed to be $250 for one qualifying child or dependent and $500 if there are two or more. I.R.C. § 21(d)(2).

    a. To be a full-time student under this rule, the 5 months do not have to be consecutive. Treas. Reg. § 1.21-2(b)(4).

    b. Qualifying educational organizations include high schools, colleges, universities, and technical, trade, and mechanical schools. On-the-job training courses, correspondence schools, or schools offering courses only through the Internet do not qualify. Pub. 503 (You Must Have Earned Income) (definition of "School").

5. Restrictions on payments to relatives. Payments to the following individuals do not qualify for the credit:

    a. To a relative if the taxpayer claims the relative as a dependent or the relative is the taxpayer's child and under age 19. I.R.C. § 21(e)(6); Treas. Reg. § 1.21-4(a)(1)-(2).

    b. Spouses. Treas. Reg. § 1.21-4(a)(3).

    c. Parent of taxpayer's child who is under age 13. Treas. Reg. § 1.21-4(a)(4).

6. Married taxpayers must file a joint return to get the credit. I.R.C. § 21(e)(2).

G. Reporting.

1. The child and dependent care credit is computed on Form 2441.

2. Except with respect to certain non-profit organizations, the taxpayer must include the name, address, and taxpayer identification number of the care provider on the taxpayer's return. I.R.C. § 21(e)(9).

a. Form W-10, Dependent Care Provider's Identification and Certification, can be used to get the necessary information from the provider.

3. The taxpayer must include the qualifying individual's taxpayer identification number on the taxpayer's return. I.R.C. § 21(e)(10).

IV. CREDIT FOR THE ELDERLY

A. References: I.R.C. § 22; Pub. 524.

B. A 15% tax credit for the elderly or the permanently and totally disabled applies to citizens or residents who are:

1. 65 years of age before the close of the tax year; or

2. Under age 65, are retired on disability, and were permanently and totally disabled when retired.

C. Married taxpayers must file a joint return to claim the credit, unless the spouses live apart throughout the tax year.

D. Income Limits. Many elderly taxpayers are not eligible for this credit because of the income limitations. Moreover, the credit is not refundable.

V. EDUCATIONAL CREDITS

A. References: I.R.C. § 25A; Pub. 970; Form 8863.

B. American Opportunity Tax Credit.

1. The American Opportunity Tax Credit is the sum of 100% of the first $2,000 of qualified tuition and related expenses, plus 25% of the next $2,000 of qualified tuition and related expenses, for a maximum credit of $2,500 per eligible student per year.

2. A taxpayer is allowed a tax credit for money spent on qualified tuition and related expenses during the first 4 years of a student's post-secondary school education (a *per-student* credit). I.R.C. § 25A(b)(2)(C).

   a. The student must carry at least half of the normal full-time workload for the course of study the student is pursuing. I.R.C. § 25A(b)(2)(B), (b)(3).

   b. Academic period includes the tax year plus the first three months of the next year. So, expenses for the spring semester paid in December count for the year. I.R.C. § 25A(g)(4).

3. The American Opportunity Tax Credit phases out ratably for taxpayers with modified AGI between statutory amounts of $80,000 and $90,000 ($160,000 and $180,000 for joint filers). I.R.C. § 25A(d).

   a. Modified AGI means AGI increased by the exclusions under I.R.C. §§ 911, 931, and 933 (foreign earned income exclusion and income sourced to United States territories).

4. Portion of the American Opportunity Tax Credit is refundable.

   a. Up to 40% of the American Opportunity Credit is refundable. I.R.C. § 25A(i).

b. The refundability rules apply only after considering other credits and the MAGI phase-out.

(1) Example: Married Filing Joint returns are eligible for a $2,500 American Opportunity Credit with a MAGI of $157,000. There is no phase-out of the credit; however, if other credits are claimed they will be applied against the taxpayer's tax liability first. If the taxpayer's tax liability is reduced to $0, then the taxpayer will qualify for a refundable American Opportunity Credit of $1,000. [$2,500 × .40 = $1,000].

(2) Example: Same example as above, except MAGI is $170,000 and therefore the phase-out applies. At this MAGI level, the taxpayer is phased out of 50% of the credit, thereby lowering the American Opportunity Tax Credit to $1,250. The credit is refundable up to 40% of the allowable credit, thus making $500 of the American Opportunity Credit a refundable credit. [$2,500 – $1,250 = $1,250 × .40 = $500].

C. Lifetime Learning Credit. I.R.C. § 25A(c); Pub. 970.

1. The Lifetime Learning Credit is a nonrefundable credit, available for any level of higher education (both credit and noncredit courses). The Lifetime Learning Credit differs from the American Opportunity credit in that it covers a broader period and range of educational courses. Whereas the American Opportunity credit applies only to the first four years of post-secondary education, the Lifetime Learning Credit applies to expenses for undergraduate, graduate, and continuing education courses. Expenses for courses of instruction at an eligible institution to acquire or improve job skills, which would not qualify for the American Opportunity Tax credit, qualify for the Lifetime Learning Credit. I.R.C. § 25A(c)(2)(B).

2. The Lifetime Learning Credit is allowed for 20% of the first $10,000 (up to $2,000) of qualified education expenses paid by the taxpayer. The maximum credit is $2,000 per return regardless of

the number of eligible students. There is no limit on the number of years the credit can be claimed for each student.

3. Double Benefit Restriction. Generally, a person who is eligible for the American Opportunity Credit is not entitled to the Lifetime Learning Credit.

   a. Unlike the American Opportunity Credit, which is available for the qualifying expenses of each qualifying student, the Lifetime Learning credit is available only per taxpayer.

   b. For example, a joint filing couple with two children could claim no more than a $2,000 Lifetime Learning credit, even if each family member is a qualifying student with qualifying expenses.

   c. Claiming more than one education benefit. A taxpayer can claim more than one education benefit in a tax year provided the same qualified expenses are not used to claim more than one benefit.

4. The Lifetime Learning Credit phases out for taxpayers with MAGI exceeding statutory threshold amounts of $40,000 or $80,000 (joint returns); these thresholds are adjusted for inflation and published annually by the IRS. I.R.C. § 25A(d)(2), (h).

D. Qualified Expenses for Education Credits:

1. Include expenses paid by the taxpayer on behalf of himself, his spouse, or any dependent of the taxpayer.

2. Qualified tuition and related expenses include tuition, fees, and expenses for course related books, supplies, and equipment only if they must be paid to the institution as a condition of enrollment or attendance at a post-secondary educational institution eligible to participate in the federal student loan program.

3. They do not include the costs of books, room and board, transportation, etc.

4. Expenses for courses involving sports, games, or hobbies do not qualify unless they are part of the student's degree program.

5. Nonacademic fees, such as student activity fees, athletic fees, insurance expenses, do not qualify. I.R.C. § 25A(f). As noted above, student-activity fees are included in qualified education expenses only if the fees must be paid to the institution as a condition of enrollment or attendance.

6. The taxpayer must reduce qualified tuition and related expenses by tax free scholarships, Pell grants, employer-provided educational assistance, veteran's benefits, and other tax-free payments. However, qualified amounts do not have to be reduced by amounts paid by gift, bequest, devise, or inheritance. I.R.C. § 25A(g)(2). In addition, no credit is allowed for any expense for which an income tax deduction is allowed. I.R.C. § 25A(g)(5).

7. American Opportunity Tax Credit only. Qualified expenses includes books, supplies, and equipment whether or not the materials are purchased from the educational institution.

E. For each eligible student, a taxpayer may claim only one of the education credits in a single tax year. I.R.C. § 25A(c)(2).

1. Must be allowed to claim the student as a dependent to qualify for the American Opportunity Tax Credit or Lifetime Learning Credits. IRC § 25A(f)(1)(A)(iii).

2. An eligible student is a person that can be claimed as a dependent. It generally includes unmarried children under age 19 or who is a full-time student under 24 if the taxpayer supplies more than half the child's support for the tax year. If another taxpayer claims the student as a dependent, the dependent cannot claim the credit, and qualified tuition and expenses paid by the dependent during the tax year will be treated as paid by the taxpayer who claims the student as a dependent. I.R.C. § 25A(g)(3).

F. Taxpayers who are married (within the meaning of I.R.C. § 7703) are not entitled to any credit unless they file a joint return. Married taxpayers incurring qualified expenses must file a joint income tax return in order to

claim the educational tax credits. No credit under I.R.C. § 25A is allowed for married taxpayers filing separate returns. To claim the credit, the taxpayer must include the student's name and social security number on his or her return.

G. Reporting. The taxpayer files Form 8863 to claim the credits.

VI. RETIREMENT SAVINGS CONTRIBUTION CREDIT

A. References: I.R.C. § 25B; Form 8880.

B. Commonly known as the Saver's Credit.

C. A nonrefundable credit based on contributions made to certain retirement accounts, such as Traditional or Roth IRA accounts or 401(k) plans.

D. The Saver's Credit applies to taxpayers with AGI (increased by exclusions under I.R.C. §§ 911, 931, and 933) below specified amounts.

1. For joint returns, heads of households, and individuals, the maximum statutory thresholds are $50,000, $37,500, and $25,000, adjusted for inflation. I.R.C. § 25B(b)(1), (b)(3). The phase-out thresholds are published annually by the IRS.

2. The credit is 50%, 20% or 10% of qualified contributions to retirement plans based on the taxpayer's filing status and AGI (as modified). I.R.C. § 25B(b)(1).

3. Taxpayer must be 18 years old or older by the end of the tax year, not a full-time student, and not claimed as dependent on another's tax return. I.R.C. § 25B(c)(1)-(2).

E. The maximum annual contribution eligible for the credit is $2,000 per person. The amount of any contribution eligible for the credit must be

reduced by any amount of taxable distribution received by the taxpayer from any such plan during the testing period.

1. The Testing Period: is the year for which the credit is claimed, the period in the following year thru the due date (with extensions) for filing the return for the earlier year, and the two tax years preceding the year for which the credit is claimed.

2. This applies to Roth distributions unless it is rolled over.

3. Example: Husband makes a $3,000 contribution to his IRA and Wife makes a $500 contribution to her IRA. The annual contribution eligible for the saver's credit is $2,500 ($2,000 from his contribution and $500 from hers).

4. Reduction example: Husband contributes $3,000 to TSP the current tax year but withdrew $900 IRA last year and a $500 withdrawal in the prior tax year. No rollover of the IRA withdrawals. Only $1,600 of the TSP contribution is eligible for the saver's credit because the withdrawals must be deducted from the contribution.

F. Types of Contributions eligible include 401(k) plans, Thrift Savings Plan contributions, IRA contributions (both traditional and Roth), SEPs, SIMPLE IRA plans, and 403(b) annuities.

G. The saver's credit is in addition to any other tax benefits of the contribution.

H. The credit is claimed on Form 8880.

VII. RESIDENTIAL ENERGY CREDITS

A. These tax-extender provisions are periodically renewed by Congress.

B. Under I.R.C. §§ 25C and 25D, taxpayers may claim nonrefundable credits for certain expenses for energy-saving property or property improvements.

C. I.R.C. § 25C, Non-Business Energy Property Credit, allows a credit for a specified percentage of the cost of certain energy saving property added to a taxpayer's residence. This includes solar water heating and solar electric property.

1. Credit Limits: Maximum credit is $500 lifetime ($200 for windows).

2. The home must be in the United States.

3. Note: Not all energy-efficient improvements qualify. Taxpayers will need to have the manufacturer's credit certification statement, usually available on the manufacturer's website or with the product's packaging.

D. Section 25D, Residential Energy Efficient Property Credit, allows for a credit equal to the applicable percent of the cost of qualified property. Qualifying properties are solar electric property, solar water heaters, geothermal heat pumps, small wind turbines and fuel cell property.

1. This property can be installed in the principal residence or the vacation home of the taxpayer, but the property cannot be used to heat a swimming pool or hot tub. I.R.C. § 25D(e)(3).

2. Additionally, the cost includes installation and labor costs as well as hardware costs.

3. There is no limit on the amount of credit available for most types of property. If your credit is more than the tax you owe, you can carry forward the unused portion of this credit to next year's tax return.

4. Fuel cell property is subject to a limitation of $500 with respect to each half-kilowatt of capacity of the qualified fuel cell property.

5. If the credit is justified by the purchase of the energy efficient property, the basis in the property is reduced by the amount of credit allowed. I.R.C. § 25D(f).

E. Claiming the credit.

1. Complete Form 5695, Part I for energy efficient property such as solar panels, solar water heaters, or fuel cell power plants under I.R.C. § 25D.

2. Complete Form 5695, Part II for non-business energy property credits under I.R.C. § 25C.

VIII. CHILD TAX CREDIT

A. References: I.R.C. § 24; Treas. Reg. § 1.24-1; Pub. 972; Form 1040, Schedule 8812.

B. A taxpayer qualifies for a credit where he or she has one or more dependents that are qualifying children and meet additional requirements. I.R.C. § 24(a).

C. The credit is subject to phase-out when a taxpayer's modified AGI exceeds certain thresholds. I.R.C. § 24(b).

1. Modified AGI is AGI plus any amounts excluded from gross income under the foreign earned income and housing exclusion or under exclusions pertaining to United States territories (Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico). I.R.C. § 24(b)(1).

2. Income excluded due to service in a combat zone under IRC § 112 is treated as earned income for purposes of the refundable child credit. I.R.C. § 24(d)(1)(B) (flush language).

D. The operation of the child tax credit in practice is complicated by the interaction of the rules for the credit with the dependent rules under I.R.C. §§ 151-152. For details and in-depth guidance, see Pub. 972.

E. For tax years 2018 through 2025, there is maximum credit of $2,000 for each qualifying child. I.R.C. § 24(h)(2). Before 2018 and after 2025, the maximum amount is $1,000. I.R.C. § 24(a).

F. A qualifying child must meet the following criteria:

1. Meet the tests for a qualifying child as a dependent, as defined in I.R.C. § 152(c). I.R.C. § 24(c).

2. Be under age 17. I.R.C. § 24(c)(1).

3. Be a citizen or resident of the United States. I.R.C. § 24(c)(2).

4. For years 2018 through 2025, have a Social Security number. I.R.C. § 24(h)(7). In other years, other identification numbers qualify. I.R.C. § 24(e)(1).

G. Credit for Other Dependents. I.R.C. § 24(h)(4)(A); Treas. Reg. § 1.24-1.

1. For years 2018 through 2025, this is a non-refundable credit up to $500 for qualifying dependents.

2. The dependent must have a Social Security number (SSN), Individual Taxpayer Identification Number (ITIN), or Adoption Taxpayer Identification Number (ATIN).

3. The credit generally applies where the child tax credit is unavailable due to age (e.g., child is age 17 or older) or because the dependent does not meet the necessary relationship test for a qualifying child.

H. Phase-out. The child tax credit phases out by $50 for each $1,000 that the taxpayer's adjusted gross income exceeds $400,000 for a joint return and $200,000 for other filing statuses.

I. Additional Child Tax Credit. I.R.C. § 24(d); Form 1040, Schedule 8812.

1. A portion of the credit may be refundable under a statutory formula. It does not affect the total tax credits allowed to the taxpayer. This is the <u>refundable</u> portion of the credit.

2. Taxpayers may be able to claim the additional credit if any portion of the regular Child Tax Credit was disallowed because tax was reduced to zero before the entire credit was used. The portion of the Child Tax Credit phased out because of AGI cannot be used to claim the additional credit. The additional credit is refundable.

3. After all the other credits are applied according to the stacking rules to reduce the taxpayer's tax liability for the year, then the refundable credits are applied. The refundable credits first reduce the taxpayer's tax liability for the year, and any remaining credit in excess of the tax liability for the year is payable to the taxpayer.

4. For years 2018 through 2025, the refundable amount of the Additional Child Tax Credit is limited to $1,400, which is adjusted for inflation. I.R.C. § 24(h)(5)(A)-(B).

J. Noncustodial parent. A noncustodial parent may claim the child tax credit or credit for other dependents where the custodial parent releases his or her claim on Form 8332 and otherwise satisfies the requirements of I.R.C. § 152(e). I.R.S. Notice 2006-86, 680. However, a noncustodial parent will not qualify for other benefits with stricter qualifications, such as the earned income credit. (See Chapter A.)

IX. ADOPTION CREDIT

A. This is a nonrefundable tax credit for qualified adoption expenses. I.R.C. § 23. The credit is claimed on Form 8839.

1. Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees and other expenses which are directly related to the legal adoption of an eligible child.

2. An eligible child is an individual who has not attained the age of 18 as of the time of the adoption or who is physically or mentally incapable of caring for himself.

B. Not available for the adoption of stepchildren or surrogate arrangements.

C. When to claim the credit depends on when the adoption was finalized and whether the child is a US citizen or foreign national.

1. US citizen (or resident alien) child.

a. Expenses in year before adoption final take in the year after expenses paid.

b. Expenses in same year as adoption final take that year.

c. Expenses paid after adoption final take in year paid.

2. Foreign national child.

a. Credit is taken in the year the adoption is finalized.

b. Expenses paid after the adoption is final can be taken in the year paid.

D. The available adoption credit begins to phase out under I.R.C. § 23(b)(2)(A) for taxpayers with modified adjusted gross income (AGI adjusted for the exclusions in I.R.C. §§ 911, 931, and 933) exceeding a statutory threshold amount of $150,000, which is adjusted for inflation and updated annually by the IRS.

E. Parents who adopted a child who has been determined to be special needs by the state or county child welfare agency can claim the maximum credit regardless of whether they have qualified adoption expenses at all.

F. A child with special needs is one who is a citizen, or resident, of the United States or its territories for whom a State has determined:

1. The child cannot or should not be returned to the home of his parents; or

2. The child would not otherwise be adopted without providing adoption assistance because of the child's ethnic background, age, or the presence of factors such as physical or emotional handicaps.

G. The IRS has concluded that adoption assistance payments made by a state to adoptive parents of special needs children are not includable in gross income. Because the payments are in the nature of general welfare, they are not includable in income, and no information reporting is required. I.R.S. Technical Assistance Memorandum, 2000-21-036 (Feb. 15, 2000), https://www.irs.gov/pub/irs-wd/0021036.pdf.

H. Can exclude up to an inflation-adjusted, statutory amount of $10,000 in employer-paid adoption expenses from income. I.R.C. § 137(b)(1), (f). Employer-provided adoption benefits are reported on W-2, box 12 with code T.

I. Carry Forward: 5 year carry forward for unused adoption credit.

X. EARNED INCOME CREDIT

A. References: I.R.C. § 32; Treas. Reg. §§ 1.32-2, 1.32-3; Pub. 596; Form 1040, Schedule EIC.

B. Overview.

1. The Earned Income Credit (EIC) is a refundable tax credit. Eligible taxpayers can receive a refund for this credit even if they owe no tax and had no income tax withheld. I.R.C. § 32.

2. The EIC provides tax relief to low-income workers, including certain workers with no children. The credit ameliorates the burden of employment taxes for low-income workers by providing a credit equal to a specified percentage of a taxpayer's earned income that does not exceed certain thresholds.

3. The credit amount rises with earned income until earned income reaches the indexed "earned income amount." The amount stays constant until earned income hits indexed "threshold amount,"

after which the credit decreases according to statutory phase-out percentage.

4. The operation of the EIC is complex and contains limitations to prevent abuse. Complications arise from the interaction between the rules for the credit and the dependent rules under I.R.C. §§ 151-152. For details and in-depth guidance, see Pub. 596.

C. Eligible taxpayers that can claim EIC:

1. The taxpayer has a qualifying child. I.R.C. § 32(c)(1)(A)(i).

a. A custodial parent may claim the credit even if that parent agrees to allow the noncustodial parent to claim the child as a dependent.

b. Married taxpayers entitled to claim a qualifying child as a dependent must file married filing jointly, unless they are deemed unmarried under I.R.C. § 7703. (See Chapter A.)

2. An individual who does not have a qualifying child may be eligible for the credit if (*i*) the principal place of residence of the individual is in the United States for more than one-half of the tax year, (*ii*) the individual (or the spouse of the individual) is at least age 25 and under age 65; and (*iii*) the individual is not claimed as a dependent by another. I.R.C. § 32(c)(1)(A)(ii).

D. Qualifying child.

1. Must meet the test of a dependent qualifying child under I.R.C. § 152(c), as determined without regard to the following:

a. The support test. I.R.C. § 152(c)(1)(D).

b. The rules for custodial versus non-custodial parents, including allowing the non-custodial to claim the child as a dependent with custodial parent's consent using Form 8332. I.R.C. § 152(e).

(1) Accordingly, a non-custodial parent cannot qualify for the earned income credit. I.R.S. Notice 2006-86, 2006-41 I.R.B. 680; Pub. 501 (Dependents – Qualifying Child of More Than One Person).

(2) The custodial parent qualifies for the EIC, if the other requirements are met, even if he or she releases the dependent for child tax credit purposes. I.R.S. Notice 2006-86, 2006-41 I.R.B. 680; Pub. 501 (Dependents – Qualifying Child of More Than One Person).

2. Does not include a married individual, unless the taxpayer is (*i*) entitled to claim the individual as a dependent or (*ii*) would be entitled to claim the individual but for the operation of the rules for custodial versus non-custodial parents. I.R.C. §§ 32(c)(3)(B), 152(c), 151(c)(1)(D), 152(e).

3. The principal place of abode of the child must be in the United States, except for a military member serving overseas on qualified extended active duty (over 90 days or for an indefinite period). I.R.C. § 32(c)(3)(C), (c)(4).

4. The child must have a Social Security number. I.R.C. § 32(c)(1)(E), (c)(3)(D), (m).

E. Earned Income.

1. A taxpayer qualifies for the credit only if he or she has taxable compensation from performing services or from self-employment. I.R.C. § 32(c)(2)(A).

a. Accordingly, income qualifying the taxpayer for the foreign earned income exclusion under I.R.C. § 911 does not apply.

2. Military taxpayers may elect to treat pay that is otherwise excluded from gross income under I.R.C. § 112 (combat zone tax exclusion) as earned income for purposes of the earned income credit. I.R.C. § 32(c)(2)(B)(vi).

3. Earned income therefore does not include income not derived from personal services, such as welfare benefits, unemployment compensation, interest, dividends, Social Security payments, pensions or annuities, and veterans' benefits. *See* Treas. Reg. § 1.32-2(c)(2).

F. Computing the EIC. The credit is determined by multiplying an individual's earned income that does not exceed a maximum amount (called earned income amount) by the applicable credit percentage. The credit is reduced by a limitation amount determined by multiplying the applicable phase-out percentage by the excess of the amount of the individuals AGI (or earned income, if greater) over the phase-out amount.

G. No credit is allowed if the taxpayer has disqualified income over a statutory amount of $2,200, adjusted for inflation and updated annually by the IRS. I.R.C. § 32(i)(1); Pub. 596 (Chapter 1 – Rule 6). Disqualified income generally includes investment income such as interest and dividends, tax-exempt interest, dividends, and capital gain distributions (including such income from a child if the parent made an election on Form 8814). Pub. 596 & Worksheet 1.

H. Improper Claims of the EIC

1. No credit is allowed (*i*) for 10 years after a year in which the taxpayer was determined to have made a fraudulent claim of the EIC; or (*ii*) for two years after a year in which the taxpayer's wrongful claim of the EIC was due to reckless or intentional disregard of the rules. I.R.C. § 32(k)(1)(B).

2. If the EIC is denied under deficiency procedures, no credit is allowed for any later tax year unless the taxpayer provides information the IRS requires demonstrating eligibility. I.R.C. § 32(k)(2); Treas. Reg. § 1.32-3; Form 8862.

XI. CONCLUSION

CHAPTER F

TAX COMPUTATION, PAYMENTS, OTHER TAXES & FINISHING THE RETURN

TABLE OF CONTENTS

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

I. REFERENCES

A. Internal Revenue Code (I.R.C.), §§ 1401-1403, 1411, 3101-3128, 3301-3311.

B. Federal Income Tax Regulations (Treas. Reg.).

C. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.

2. Pub. 17, Your Federal Income Tax.

3. Pub. 334, Tax Guide for Small Business

4. Pub. 926, Household Employer's Tax Guide

D. Tax Forms: 1040, Schedule SE, 6251, 4137, 5329, 5405, 8888, 8812, 8863, Schedule H (Household Employment Taxes).

II. CALCULATING THE TAX

A. Introduction: After you have figured your income and deductions, the next step is to calculate the tax.

B. Ordinary Income.

1. The income tax liability is based on the taxpayer's taxable income.

2. After figuring the income tax, subtract tax credits and add any other taxes owed. The result is the total tax liability. Compare the total tax with the total payments to determine whether the taxpayer is entitled to a refund or owes additional tax.

3. Most taxpayers use computer software to calculate the taxpayer's liability.

a. For taxpayers with less than $100,000 of taxable income and who do not use computer software to prepare their returns, the IRS requires use of the annually published Tax Table to compute their final tax liability. Instructions to Form 1040.

b. If such taxpayers have taxable income over $100,000, they must compute their tax liability using the appropriate section of the IRS's Tax Computation Worksheet corresponding to their filing status. Instructions for Form 1040.

C. Capital Gain.

1. If the taxpayer has a net capital gain or qualified dividends for the year, the computation of tax liability requires consideration of capital gains tax rates.

2. Recall that capital gains are taxed at more favorable rates than ordinary income.

a. Ordinary Income: 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

b. Capital Gains: 0%, 15%, 20%, 25% (unrecaptured Section 1250 gain), and 28% (collectibles), as well as a special 3.8% surtax (Net Investment Income Tax) in some cases.

c. Capital gains rates operate differently in years 2018 through 2025 compared to other years. The rates remain 0%, 15%, and 20%, but the rates apply at brackets that operate independently of the taxpayer's marginal rate. I.R.C. § 1(j)(5). The special rates of 25% for unrecaptured Section 1250 gain and 28% for collectibles still apply.

3. Schedule D and Form 8949, and their attendant worksheets, segregate ordinary income from capital gains and categorize the various types of capital gain. Capital gain is then taxed at the favorable rates listed above, and the taxpayer's overall tax liability is reduced as appropriate.

III. TOTAL TAX

A. A taxpayer's income tax is based on his or her taxable income, as determined by determining the taxpayer's income and deductions.

B. After the taxpayer's income tax and AMT, if any, is determined, the taxpayer must subtract any applicable tax credits and add any other taxes owed. The result is the taxpayer's total tax.

C. The taxpayer's total tax is compared to his or her total tax payments (e.g. withholdings as shown on the taxpayer's W-2) to determine if a refund or additional tax payment is warranted.

IV. OTHER TAXES

A. Self-employment Tax (Schedule SE).

1. An individual who is self-employed is subject to the self-employment tax, the purpose of which is to provide social security benefits. This tax is assessed on the individual's self-employment income. I.R.C. § 1401-1402.

2. It does not include rental income (unless taxpayer is a real estate dealer), dividends, or capital gains.

3. Individuals that had net earnings from self-employment over $400 are subject to the tax.

4. Net earnings from self-employment consists the gross income derived from any trade or business, less allowable deductions attributable to the trade or business and the taxpayer's distributive

share of the ordinary income or loss of a partnership engaged in a trade or business. Treas. Reg. § 1.1402(a)-1.

5. There are special rules for computing net earnings from self-employment. I.R.C. § 1402(a).

   a. I.R.C. § 199A. Section 199A allows a 20% deduction, subject to numerous limitations, to taxpayers operating a trade or business other than through a corporation.

6. The combined rate of tax on self-employment income is 15.3%. That rate consists of a 12.4% for social security, and a 2.9% component for Medicare. Beginning in 2013, there is a 3.8% (2.9% regular Medicare tax plus 0.9% additional Medicare tax) on all self-employment income in excess of $200,000 ($250,000 of combined self-employment income on a joint return, $125,000 for married taxpayers filing a separate return. I.R.C. § 1401(b)(2). Use Form 8959, Additional Medicare Tax, to figure the additional Medicare tax.

7. Self-employment income is subject to tax only up to a maximum amount under the Social Security Act, which is adjusted for inflation and published annually by the IRS. I.R.C. § 1402(b)(1); 42 U.S.C. § 430. There is no longer a cap for the Medicare component.

8. The self-employment tax is calculated on the Schedule SE.

   a. The self-employment tax will be entered on line 5 of Schedule SE.

   b. The self-employment tax will carry over to Form 1040.

   c. As previously mentioned, a deduction for one-half of the self-employment tax is indicated on Schedule SE, line 6, and transferred to Form 1040 as an adjustment to income.

   d. Married couples filing a joint return must file separate Schedules SE where each spouse is self-employed.

9. U.S. Citizens or Resident Aliens Living Outside the U.S. I.R.C. § 1402(a)(11):

   a. In most cases, self-employed U.S. citizens or resident aliens living outside the U.S. must pay the self-employment tax. The taxpayer may not reduce foreign earnings from self-employment by the foreign earned income exclusion.

   b. The U.S. has social security agreements with many countries to eliminate dual taxes under two social security systems. Under these agreements, the taxpayer must generally pay social security and Medicare taxes to only the country where they reside.

   c. The U.S. now has social security agreements with Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, South Korea, Sweden, Switzerland, the United Kingdom, and the Slovak Republic (as of May 1, 2014). Additional agreements are expected in the future.

B. Alternative Minimum Tax (AMT) (Form 6251).

1. The AMT rules have been devised to ensure that at least a minimum amount of tax is paid by high income taxpayers who reap large tax savings by making generous use of certain tax deductions and exemptions. Without the AMT, some taxpayers might be able to escape income taxation entirely. The AMT is a separate tax system with its own set of rules. I.R.C. § 55.

2. The AMT is the excess, if any, of the tentative minimum tax for the year over the regular tax for the year.

3. No specific tests to determine if taxpayer owes AMT. Figure regular income tax and then see whether tax benefit items must be added back (see Form 1040 Instructions).

4. Taxpayer uses Form 6251 to determine liability. See Instructions to Forms 1040 and 6251 for further information about the AMT, including current rates and brackets.

C. Social Security and Medicare Tax on tip income not reported to employer (Form 4137).

1. Cash tips paid directly to an employee by a customer and tips paid over to the employee for charge customers must be accounted for by the employee in a written statement furnished to the employer on or before the 10th day of the month following the month when they are received, unless the tips received by the employee in the course of employment by a single employer amount to less than $20 in a calendar month. I.R.C. § 3121(a)(12); 3401(a)(16); 6053(a).

2. All of the tips mentioned above are subject to withholding. I.R.C. § 3401(a)(16)(B). However, the only tips that an employer must report on Form W-2 are those that are actually reported to him by the employee. I.R.C. § 6051(a).

3. If a taxpayer received tips of $20 or more in any month and did not report the full amount to their employer, they must pay the Social Security and Medicare tax on the unreported tips.

4. The tax is computed on Form 4137, and the amount of the tax transferred to Form 1040.

5. A taxpayer may be charged a penalty equal to 50% of the social security and Medicare tax due on tips if they did not report them to their employer.

D. Net Investment Income Tax. I.R.C. § 1411.

1. For tax year 2013 and beyond, certain unearned income of individuals, trusts, and estates is subject to a 3.8% surtax (i.e., it is payable on top of any other tax payable on that income).

2. For individuals, the surtax on unearned income (also called the unearned income Medicare contribution tax or the net investment income tax) is 3.8% of the lesser of:

   a. Net investment income; or

   b. The excess of modified adjusted gross income (MAGI) over an unindexed threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case).

3. Net Investment Income is the excess of the sum of the following items over investment expenses (except interest) directly connected with the production of investment income [Treas. Reg. §1.1411-4]:

   a. Gross income from interest, dividends, annuities, royalties, rents, and substitute interest and dividend payments, but not to the extent this income is derived in the ordinary course of an active trade or business;

   b. Other gross income from passive activity under I.R.C. § 469, or from a trade or business of a trader trading in financial instruments or commodities; and

   c. Net gain included in computing taxable income that is attributable to the disposition of property, but not to the extent the property was held in an active trade or business.

4. The net investment income is reported on IRS Form 8960.

E. Tax on Unearned Income of Children – "Kiddie Tax"

1. Under the "kiddie tax" rules, certain children are taxed at higher rates on unearned income. The tax applies where the child's unearned income exceeds a statutory threshold of $500, as adjusted for inflation by the IRS. I.R.C. §§ 1(g)(7)(A), 63(c)(5)(A).

2. The parents may elect, if certain conditions are met, to include the child's gross income on their own return.

3. A child is subject to the kiddie tax if:

   a. The child either –

      (1) Is under age 18 at the end of the tax ear, or

      (2) Is age 18, or 19-23 if a full-time student, at the end of the tax year and his or her earned income does not exceed one-half of the child's support;

   b. Either parent is alive at the end of the tax year;

   c. The child does not file a joint return for the tax year; and

   d. The child's unearned income is more than a threshold amount published by the IRS. I.R.C. § 1(g)(2).

4. A child subject to the kiddie tax pays a tax computed on Form 8614, attached to the child's Form 1040.

5. The parents of a child may elect to include on their return the unearned income of a child to avoid the kiddie tax. The election can only be made under certain enumerated requirements. I.R.C. § 1(g)(7). The election is made by filing Form 8814.

F. Additional tax on IRAs, qualified plans and other tax-favored accounts (Form 5329).

1. Taxpayer includes distributions received before age 59½ in gross income. In addition, the taxpayer must pay a 10% penalty. Withdrawals before age 59½ are called premature or early withdrawals. This penalty is 10% of the part of the distribution that the taxpayer must include in gross income.

2. Additional 10% penalty is imposed on the premature withdrawal from an IRA, or other qualified retirement plan. This tax is in addition to any regular tax due.

3. There are a number of exceptions to the 10% penalty, if one applies see the instructions for Form 5329 for the code to place on the form to exempt the distribution from the penalty:

   a. The receipt of a distribution from a traditional IRA that includes a return of nondeductible contributions is not subject to the 10% penalty.

   b. The 10% penalty does not apply if taxpayer dies, or becomes disabled. I.R.C. § 72(t)(3)(A).

   c. Unemployed individuals: To the extent that they do not exceed qualifying medical insurance premiums, distributions by an IRA to certain unemployed individuals are not subject to the 10% penalty. I.R.C. § 72(t)(2)(D).

   d. Qualified higher education expenses: The 10% penalty will not be charged if the individual uses the IRA money to pay for qualified higher education expenses for the individual, the spouse, child, or grandchild of the individual or their spouse. Qualified expenses for this exception are the same as for education credits. I.R.C. § 72(t)(2)(E).

   e. First time homebuyer expenses: The 10% penalty will not be charged if the individual uses the IRA money for certain expenses associated with buying a principal residence. Only $10,000 during the individual's lifetime may be withdrawn without a penalty for this purpose. I.R.C. § 72(t)(2)(F).

      (1) Qualified expenses include acquisition costs, settlement charges and closing costs.

      (1) The principal residence may be for the individual or the individual's spouse, child, grandchild or ancestor.

(2) In order to be considered a first-time homebuyer, the individual must not have had an ownership interest in a principal residence during the two-year period ending on the date that the new home is acquired. I.R.C. § 72(t)(8)(D) (principal residence as defined in I.R.C. § 121).

f. Annuity exception. Taxpayer may receive distributions without penalty if distributions are part of a series of substantially equal payments over taxpayer's life, even if taxpayer is less than age 59½. Two special requirements:

(1) At least 1 distribution annually; and

(2) Distribution payments continue for at least 5 years or until taxpayer reaches 59½, whichever is longer.

g. If a taxpayer made a contribution to an IRA during the tax year, and withdraws the money before the due date of the tax return, he will not be subject to the 10% penalty. If a taxpayer has an extension of time to file a tax return, the taxpayer can withdraw the money from the IRA tax free by the extended due date. However, the taxpayer must also withdraw any interest or other income earned on the contributions and include that in income.

h. Qualified Reservist Distribution. No penalty if ordered to active duty after 11 September 2001 for at least 180 days and a distribution is taken during a time of active duty. I.R.C. § 72(t)(2)(G).

4. Taxpayers receiving premature distributions must complete IRS Form 5329 and enter the amount of the tax on Form 1040.

G. Household Employment Taxes. Form 1040, Schedule H; Pub. 926.

1. If a taxpayer employs someone to care for children or disabled dependents in their home (clean, cook, or provide other personal services in or around the home) the taxpayer may be obligated to pay and withhold Social Security and Medicare taxes (FICA) and

also pay federal unemployment taxes (FUTA). FICA or FUTA taxes do not apply if the household worker is the employee of an agency that assigns the position, sets the fee, and requires reports from the worker.

2. "Nanny tax."

   a. There is an annual wage threshold per domestic employee for Social Security taxes on wages earned by domestic service employees. I.R.C. § 3121(a)(7)(B).

   b. An employer of household employees is liable for FUTA taxes if they paid cash wages of $1,000 or more for household services during any calendar quarter, or if they did so in any quarter in the preceding year. However, you do not have to count wages paid to your spouse, your child who is under 21, or to your parent.

   c. Household employers report and pay Social Security, Medicare or Federal Unemployment (FUTA) taxes annually on their own federal income tax return (see Schedule H).

   d. Additional Medicare Tax applies to an individual's Medicare wage that exceeds a threshold amount based on the taxpayer's filing status. Employers are responsible for withholding the 0.9% Additional Medicare Tax on an individual's wages paid in excess of $200,000 ($250,000 MFJ; $125,000 MFS) in a calendar year.

   e. A taxpayer should file a Form W-2 for each household employee to whom they paid Social Security and Medicare wages, or wages from which the taxpayer withheld federal income tax.

   f. Employers need an employer identification number (EIN) to include on Form W-2 and Schedule H. To obtain an EIN, employers should complete Form SS-4.

g. Household workers under age 18 are exempt from Social Security taxation and coverage UNLESS their principal occupation is household employment.

3. The tax is computed on Schedule H and entered on Form 1040.

V. CREDITS

A. A credit is a dollar-for-dollar reduction of the taxpayer's tax liability.

1. After the taxpayer determines his or her income tax and any AMT, the taxpayer should determine if he or she is eligible for any tax credits.

2. *See* Tax Credit outline for a list of credits and their eligibility requirements.

B. Other Credits. Excess Social Security and RRTA tax withheld. I.R.C. § 31(b)(1).

1. If a taxpayer or spouse had more than one employer for the tax year and had total wages of more than the applicable ceiling for the year, too much social security tax may have been withheld.

2. Taxpayers can claim a credit on Form 1040 for the amount of social security tax withheld in excess of the maximum.

3. If any one employer withheld more than the maximum amount, the taxpayer must ask the employer to refund the excess.

VI. PAYMENTS

A. Federal income tax withheld from Forms W-2 and 1099.

1. Withholding of income tax by an employer is required only on an employee's wages. I.R.C. § 3401(a).

2. Salaries, fees, bonuses, commissions on sales or on insurance premiums, taxable fringe benefits, pensions and retirement pay (unless taxed as an annuity) are, if paid as compensation for service, subject to withholding. Treas. Reg. § 31.3401(a)-1(a)(2).

3. Wage withholding is a pay-as-you-earn tax system. Federal income tax taken out of the taxpayer's pay is shown in box 2 of Form W-2.

4. Federal income tax can also be withheld on payments from pension plans, annuities, and IRAs. The tax withheld is reported on Form 1099-R, box 4.

5. Some income tax is withheld from income reported on other Form 1099s.

6. Add all of the federal income tax withheld from the above sources and enter on Form 1040.

B. Estimated Tax Payments and Amount Applied from Prior Year Tax Return. (Form 1040-ES).

1. An individual must make four quarterly installment payments of estimated tax based on the amount of his "required annual payment" to avoid an underpayment penalty. The required annual payment is the lower of 90% of the tax shown on the current year return or 100% (110%, for high income individuals) of the tax shown on the prior year return.

   a. Taxpayers make estimated tax payments on income that is not subject to withholding or when the tax withheld is inadequate.

   b. Taxpayers use Form 1040-ES to make estimated tax payments. If the taxpayer made estimated tax payments during the tax year the total amount of the payments is entered on Form 1040.

2. If the taxpayer had an overpayment and applied part or all of it to their estimated tax in the current year, indicate the amount on Form 1040.

C. Amount Paid with Request for Extension to File.

1. If the taxpayer filed Form 4868 or used a credit card to get an automatic extension of time to file Form 1040, the taxpayer enters any amount that was paid with the extension form or by credit card.

2. If the taxpayer paid by credit card, the amount of the convenience fee charged by the credit card company is not included in the payment.

D. Other Payments. Forms 2439, 8801, 8839, 8885.

1. Any tax paid by a regulated investment company or real estate investment trust may provide a tax credit to taxpayer on Form 2439: Notice to shareholder of undistributed long-term capital gains.

2. Any tax credit available to taxpayer from qualified adoption credits is reported on Form 8839.

3. Any tax credit available to taxpayer from federal tax paid on health insurance is calculated on Form 8885.

4. A taxpayer with any of these three types of credits checks the appropriate box and enters the credit on Form 1040.

E. Total Payments.

1. All payments are added together.

2. The sum is the total tax paid during the tax year.

VII. REFUND

A. If the taxpayer has made more tax payments during the tax year than the total tax due, the taxpayer has overpaid taxes for the tax year.

B. The taxpayer can elect to have an overpayment refunded. This will result in a check mailed to the taxpayer, direct deposit of the refund if elected by the taxpayer, or the taxpayer can elect to use the refund to purchase Series I Savings Bonds.

C. The taxpayer can elect to have a refund direct deposited to a bank account using Form 8453.

1. Double-check routing number and account number with a voided check.

2. Require proof of ownership of account.

a. *NOTE*: A military employee used the Volunteer Income Tax Assistance (VITA) program to electronically file her return. A person with access to the VITA site changed the bank deposit account and routing numbers, causing the refund to be deposited into a service member's bank account. The service member immediately spent the money, but denied having knowledge of how it got in his account. Although the military suspected that the sailor had a friend with access to the VITA computers and that that person changed the bank routing and account numbers, it filed no charges in the case. After reimbursing the employee for the missing refund, the military asked the IRS to refund the misappropriated money to the employee so she could reimburse the military. The IRS concluded it may issue a second income tax refund to an individual whose electronic refund deposit was fraudulently re-routed to a third person. I.R.S. Field Service Advice, FSA 2000-38-005 (June 6, 2000).

D. Split Refunds. Form 8888.

1. Taxpayers have the option to divide their direct deposit refund between a maximum of three different accounts.

2. The accounts must be maintained in U.S. financial institutions.

3. To split a refund, the refund amount must be at least $1.00 or more.

4. Refunds can be split to various accounts as long as the account is one with a routing number and account number. This includes, savings accounts, checking accounts, IRAs, money markets, debit cards, and education savings accounts. A refund cannot be directed to a loan account.

5. Ordering Rules.

   a. IRS must reduce the refund: Bottom-up rule.

      (1) The IRS will first deduct the difference from the amount designated for the last listed account on the Form 8888.

      (2) If the difference exceeds the refund designated for this account, the IRS will go to the next listed account, etc.

   b. IRS must increase the refund: All to the last account listed.

   c. IRS offset: If the IRS offsets a refund for delinquent state income taxes, back child support, or delinquent federal debts like student loans, the FMS will deduct the amount due from the account that appears first on the payment file received by FMS from the IRS. The IRS payment file orders accounts from the lowest to the highest routing number—which may not correspond with the split-refund order rules.

6. Anyone whose refund is changed will receive a letter from the IRS explaining the adjustments.

7. Anyone who wants a direct deposit into a single account does not use the Form 8888, they still simply indicate the routing and account numbers on the Form 1040.

E. Refund Offset:

1. If a taxpayer owes a past-due federal tax, state tax, child support, spousal support, or certain federal nontax debts, such as student loans, all or part of an overpayment (refund) may be used to pay the past-due amount.

a. Priorities for Offset.

(1) First, by amount of any past-due support assigned to a state;

(2) Second, by the amount of any past-due, legally enforceable debt owed to a federal agency;

(3) Third, by the amount of any qualifying past-due support not assigned to a state; and

(4) Fourth, by the amount of any past-due legally enforceable state income tax obligation.

b. States can seek an offset for federal income tax refunds payable after December 31, 1999. I.R.C. § 6402(e)(2). As extended to state income tax debts, the program allows the state taxing authorities to ask the federal government to offset a taxpayer's federal income tax refund against the taxpayer's state income tax liabilities. Thus, the federal government acts as a collection arm for the states. 31 C.F.R. Part 285; 64 F.R. 71228 (December 20, 1999).

(1) The state first must show that is has made reasonable efforts to collect the tax.

(a) The term "State" means not only the States of the United States, but includes the District of Columbia, American Samoa, Guam, the U.S. Virgin Islands, Commonwealth of the Northern Mariana Islands, and the Commonwealth of Puerto Rico.

(b) "State income tax" includes all taxes determined under state law to be State income tax, and includes any local income tax that is administered by the chief tax administering agency of the State.

(2) Second, the state must notify the taxpayer of its intent to offset the taxpayer's federal refund claim and give the taxpayer 60 days to demonstrate that the state tax levy is not past due or not unenforceable.

(3) States are required to certify compliance with pre-offset procedures imposed by state law or procedures.

(a) The certification and pre-offset procedures include a requirement that states provide debtors with notice that they intend to collect the debt by referral to the Treasury for tax refund offset;

(b) That states afford debtors the opportunity to present evidence that all or part of the debt is not due; and

(c) That states establish procedures for reviewing evidence presented by debtors.

(4) For refunds payable after December 31, 1999, the IRS will only be able to apply a refund for a tax year to offset state tax obligations if the address shown on the Federal return for the year of the overpayment is within the state seeking the offset.

(a) If the taxpayer moves to a different state, he or she is effectively exempt from application of a refund for a year after the move.

(b) The address shown on the return is controlling for this purpose. Thus, literally read, even if a taxpayer actually continues to reside within the state seeking the offset, if he files the return showing an address outside that state, IRS cannot apply the refund offset.

(5) The reduction of a taxpayer's refund for past due State tax is not subject to review by any court of the U.S. or by the Secretary of the Treasury, Financial Management Service, or the I.R.S. in an administrative proceeding. I.R.C. § 6402(f).

2. A taxpayer subject to offset will receive a notice from the Treasury Department's Financial Management Service showing the amount of the offset and the agency receiving it.

VIII. AMOUNT OWED

A. If the total tax due is more than the total tax payments for the tax year, then the taxpayer will owe money.

1. The amount owed will be indicated on Form 1040.

2. If there is an amount owed, the taxpayer should include with the tax return, a check or money order payable to the United States Treasury for the entire amount owed.

3. The taxpayer may use a credit card to pay amount owed. The credit card company usually charges a convenience fee that varies by card service.

4. The taxpayer can pay by electronic debit from a bank account.

5. The payment should be enclosed, but not attached to the return. The taxpayer's name, address, social security number, daytime telephone number, and "[Year] Form 1040" should be written on the payment.

6. If the taxpayer cannot pay the full amount, he or she can ask for permission to make monthly installment payment. To ask for an installment agreement, the taxpayer should file an Installment Agreement Request (Form 9465) with the tax return.

    a. On Form 9465, the taxpayer may request a monthly payment plan. The IRS will inform the taxpayer within 30 days if the proposed payment plan is accepted.

    b. If the monthly payment plan is approved, the taxpayer will have to pay a processing fee, interest, and possibly a late-payment penalty on the amount not paid by the due date.

    c. If the taxpayer owes $10,000 or less and certain conditions are met, the IRS must enter into an installment arrangement if requested. The taxpayer must show that full payment cannot be currently made, and that in the previous five years the taxpayer filed income tax returns and paid the tax and did not enter into an installment arrangement during that period.

    d. If amount due, including interest and penalty, is $25,000 or less, the taxpayer can apply online for an installment agreement at www.irs.gov.

B. Estimated Tax Penalty.

1. If the amount owed is $1,000 or more and it is more than 10% of the tax shown on the return, or if the taxpayer underpaid his prior year estimated tax liability, the taxpayer may owe a penalty for underpayment of estimated tax.

2. If the exceptions to the penalty do not apply to the taxpayer, the penalty is calculated on Form 2210 or you can allow the IRS to make the calculation and notify the taxpayer of the penalty.

3. A taxpayer subject to the estimated tax penalty will include the penalty on Form 1040.

IX. FINISHING THE RETURN

A. Taxpayer Identification Section.

1. Signature Section.

a. Electronic Filing: Return still has to be signed to be validly filed if it is electronically submitted. The signature form is Form 8879, generated by the software.

(1) Use the Practitioner Pin method for your tax center. The Practitioner Pin will be your center's EFIN and 98765 which designates the return as a VITA return.

(2) The Form 8879 no longer has to be maintained by the tax center for 3 years. However, military tax centers must retain Form 8879 thru 31 December of the filing year.

(3) If a POA is used or a Form 8332, giving dependent exemption to non-custodial parent, must file a Form 8453 in addition to Form 8879. Form 8453

transmits the attached POA or Form 8332, and the Form 8879 is still the signature document.

b. Joint return:

(1) How to get both husband and wife signature on a joint return in a tax center?

(2) Require both husband and wife to come into tax center at the same time?

(3) System to allow for one spouse to come into tax center (without children), prepare return, sign return, and then the other spouse to return later to sign the return.

c. When a signature appears on a joint tax return, there is a rebuttable presumption that each spouse has signed his/her name. I.R.C. § 6064.

(1) In the past, the Internal Revenue Manual instructed IRS agents that a signature on a return was prima facie evidence that the person whose name appears on the document actually signed the return and to disallow any claim that a spouse's signature on a joint return was forged.

(2) A spouse who files a joint return can rebut the presumption under I.R.C. § 6064 that she actually and willingly signed a joint return. The spouse seeking relief must prove that the signature was forged and he/she did not intend to file a joint return. I.R.S. Legal Memorandum 1999-43-001, Processing Claims of Forged Returns (November 2, 1998).

d. Generally, the taxpayer must sign the tax return. However, if the military taxpayer is overseas or incapacitated, the service member can grant a power of attorney to an agent to file and sign the return. Pub. 3.

B. Third Party Designee: There is a section to give permission to the IRS to talk to the tax return preparer or other designee and bypass the filer to discuss questions or issues regarding processing related matters on the returns.

1. In the past, tax practitioners (attorneys, CPAs, and enrolled agents) and other paid preparers needed a power of attorney in order to discuss tax return preparation, and refund and payment issues with the IRS.

2. Under this option, the taxpayer's designee has the ability to speak directly to the IRS Customer Service representatives over the telephone and in person in response to math error notices and to receive information about a refund or payment. It should be noted that the authorization cannot be revoked by the taxpayer. Nevertheless, the authorization will automatically end no later than the due date (without regard to extensions) for filing the next year's tax return.

3. The checkbox initiative eliminates the need for the power of attorney only for certain matters. The taxpayer's designee is limited to issues arising during the process of that specific return. The taxpayer will still need to sign a power of attorney for examination matters, under reported income, appeals and collection notices.

X. GENERAL INFORMATION

A. Change of address. The taxpayer can notify the IRS of a change in address by stating the new address on the return, sending Form 8822, making a written statement and sending it to the IRS, or calling the IRS.

B. Record Keeping. In general, taxpayers should keep their returns for as long as the returns may be needed for the administration of any provision of the Internal Revenue Code. In other words, keep the tax returns until the applicable statute of limitations have run. See Pub. 17, Table 1-7.

C. Amended returns.

1. A taxpayer may file a refund claim on Form 1040-X within three years from the time the return was filed, or within two years from the time the taxpayer paid the tax, whichever is later.

2. In determining the time limits within which a refund claim may be filed, the taxpayer may disregard intervening periods of service in a CZ/QHDA, plus periods of continuous hospitalization outside the U.S. as a result of combat zone injury, and the next 180 days thereafter.

D. Copies of Returns. To obtain an exact copy of past tax returns, file Form 4506 (Request for Copy of Tax Return).

XI. CONCLUSION

CHAPTER G

STATE INCOME TAXATION, THE SCRA, AND THE MSSRA

TABLE OF CONTENTS

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

I. REFERENCES

A. 50 U.S.C. §§ 3901 et seq.

B. The Servicemembers Civil Relief Act (SCRA): Section-by-Section Summary, Congressional Research Service (updated March 25, 2019), https://crsreports.congress.gov/product/pdf/R/R45283.

II. INTRODUCTION

A. THE AUTHORITY OF THE STATE TO TAX.

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

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

3. Definitions:

a. Domiciliary – "Someone who resides in a particular place with the intention of making it a principal place of abode …." Black's Law Dictionary (10th ed. 2014).

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

(1) Indicia of domicile:

(a) Expressed intent, oral or written;

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

(c) Residence of immediate family. *See* United States v. Minnesota, 97 F. Supp. 2d 973 (D. Minn. 2000) (residence of non-military spouse not controlling factor nor gives presumption of domicile for military member);

(d) Location of schools attended by children;

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

(f) Payment of taxes (income and personal property). [Important factor] *But see* Wolff v. Baldwin, 9 N.J. Tax 11, 19-20 (N.J. Tax Court 1986) (one cannot establish domicile by paying taxes alone; physical presence is also necessary);

(g) Ownership of real property [Important factor];

(h) Leasehold interests;

(i) Situs of personal property.

(j) Voter registration. [Important factor.] *See* Cal. Franchise Tax Board Legal Ruling No. 54, Residence: Effect of Military Personnel Registering to Vote, 1958 Cal. FTB LEXIS 54 (Cal. FTB 1958); Captain Albert (vice) Gilbert Veldhuyzen and Commander Samuel F. Wright ARMY LAW. article, "*Domicile of Military Personnel for Voting and Personnel*," Sept. 92 at 15; *Zavadil v. Comm'r of Revenue*, No. 8433-R, 2015 Minn. Tax LEXIS 16, at *61 (Minn. T.C. Mar. 18, 2015) (noting that lack of participation in voting suggests absence of community ties).

(k) Vehicle registration. [Important factor] See *Matter of Karsten*, 924 P.2d 1272 (Kan. Ct. App. 1996) (voluntary registration of motor vehicle does not automatically change domicile);

(l) Motor vehicle operator's permit. [Important factor, but not controlling by itself] *See* Va. Dep't of Taxation P.D. 99-132, 1999 Va. Tax LEXIS 131 (June 7, 1999); Va. Dep't of Taxation P.D. 16-136, https://tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/16-136 (because service members and spouses are exempt from requirement to obtain Virginia driver's license, obtaining one is indicator of intent to change domicile);

(m) Location of bank and investment accounts;

(n) Explanations for temporary changes in residence;

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

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

(q) Place of marriage;

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

(s) Place of birth;

(t) Business interests;

(u) Sources of income;

(v) Outside employment;

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

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

(y) Address provided on federal income tax return;

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

(aa) Ownership of burial plots;

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

(cc) Location of donees of charitable contributions.

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

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

(b) *See* 305 ILL. COMP. STAT. ANN. § 5/2-10 (LexisNexis 2017) (residence of married woman shall be that of her husband unless they are living separate and apart, in which case she may acquire a separate residence).

(c) *See also* Restatement (Second) of Conflicts § 21 (1988) ("[T]here were at least two reasons for the common law rule.... [First,] 'the very being or legal existence of the woman is suspended during marriage, or at least is incorporated and consolidated into that of the husband.' … This view is no longer held. The second reason for the common law rule was the desirability of having the interests of each member of the family unit governed by the same law.").

(d) More states, however, provide that a woman's domicile is established independently of her husband. These states include, among others, California,

Colorado, Georgia, Minnesota, New Jersey, New York, North Dakota, Pennsylvania, Virginia, and Washington.

(e) *See Kerr v. Kerr*, 371 S.E. 2d 31 (Va. Ct. App. 1988)(outmoded expectation that a wife is expected to follow her husband's change of abode is no longer applicable).

(f) *See United States v. Minnesota*, 97 F. Supp. 2d 973 (D. Minn. 2000) (state cannot rely on non-military spouse's domicile to determine domicile of military member).

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

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

(2) *Residence* means the "place where one actually lives, as distinguished from a domicile. … *Residence* usu[ally] just means bodily presence as an inhabitant in a given place; *domicile* usu[ally] requires bodily presence plus an intention to make the place one's home. A person thus may have more than one residence at a time but only one domicile." Black's Law Dictionary (10th ed. 2014) (emphasis in original).

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

(1) CAL. REV. & TAX. CODE § 17014(a) (Deering 2017) ("Resident" includes: (1) Every individual who is in this state for other than a temporary or transitory purpose....") and § 17016 ("Every individual who spends in the aggregate more than nine months of the taxable year within this State shall be presumed to be a resident. The presumption may be

overcome by satisfactory evidence that the individual is in the State for a temporary or transitory purpose.") (emphasis added).

e. Nonresidents – are ordinarily defined in the negative: "Someone who does not live within a particular jurisdiction." Black's Law Dictionary (10th ed. 2014).

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

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

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

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

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

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

(4) *See, e.g.*, N.Y. Tax Law § 605 (Consol. 2017) ("A resident individual means an individual … who is domiciled in this state, unless he maintains no permanent place of abode in this state, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in this state."); *see also Matter of Gatchell*, https://www.dta.ny.gov/pdf/archive/STC/Personal/1984/a_l0170.pdf (service member who lived in military barracks did not have "permanent place of abode" and did not receive income tax exemption).

5. Change of Legal Residence/Domicile.

a. Physical presence in the new state. *See Juskowiak v. Comm'r of Revenue*, No. 6607, 1996 Minn. Tax LEXIS 17 (Minn. 1996); *Wolf v. Comm'r of Revenue*, No. 7068, 1999 Minn. Tax LEXIS 41 (Minn. 1999); Letter No. IT 96-0010, 1996 WL 305698 (Ill. Dept. Rev. 1996) (problems of JAG officer claiming change of legal residence from Wisconsin to Illinois), AND

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

c. DD Form 2058 (Appendix B).

d. *Carr v. Dep't of Revenue*, No. TC-MD 040979A, 2005 WL 3047252 (Or. T.C. Nov. 4, 2005). Service member purchased a home and registered vehicles in Oregon and asserted no intention of remaining in Oregon after military service. Service member asserted that Nevada was his state of domicile. State tax court concluded that service member had no connections to Nevada since he owned no property in Nevada, was not registered to vote in Nevada, did not have a Nevada driver's license, and did not have any vehicles registered in Nevada. Service member could not just assert a domicile, must also have connections with that state.

III. PRINCIPLES OF THE SERVICEMEMBERS' CIVIL RELIEF ACT

A. 50 U.S.C. § 4001 provides that:

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

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

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

B. Section 4001 protects military income from double taxation because:

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

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

C. Section 4001 is constitutionally valid. *Dameron v. Broadhead*, 345 U.S. 322 (1953) (predecessor provision).

D. A service member's nonmilitary income is not protected from double taxation by Section 4001. Nonmilitary income can be taxed by:

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

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

E. Native American Military Member Exception. *Fatt v. Utah State Tax Comm'n*, 884 P.2d 1233 (Utah 1994); 50 U.S.C. § 4001(f) ("An Indian servicemember whose legal residence or domicile is a Federal Indian reservation shall be taxed by the laws applicable to Federal Indian reservations and not the State where the reservation is located.").

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

A. On 31 December 2018, the Veterans Benefits and Transitions Act of 2018 (VBTA), Pub. L. No. 115-407 took effect. Section 302 of the VBTA allows the spouse of a Servicemember to elect the same residence as the Servicemember for state and local tax purposes. Section 302 will significantly impact the efforts by certain states to impose income and personal property taxes upon military spouses. The text of this

outline in italics below reflects the state of the law before the passage of the VBTA. See Appendix F, Information Paper dated 11 January 2019, for more information.

B. Military Spouses Residency Relief Act of 2009. Spouses who meet the domicile test (i.e., physical presence and the intent to make the state their permanent home) will receive protections similar to protections provided by the SCRA to service members. "A spouse of a servicemember shall neither lose nor acquire a residence or domicile for purposes of taxation with respect to the person, personal property, or income of the spouse by reason of being absent or present in any tax jurisdiction of the United States solely to be with the servicemember in compliance with the servicemember's military orders if the residence or domicile, as the case may be, is the same for the servicemember and the spouse. … Income for services performed by the spouse of a servicemember shall not be deemed to be income for services performed or from sources within a tax jurisdiction of the United States if the spouses is not a resident or domiciliary of the jurisdiction in which the income is earned because the spouse is in the jurisdiction solely to be with the servicemember serving in compliance with military orders." 50 U.S.C. § 4001(a)(2) and (c) (emphasis added).

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

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

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

people know that they intend a certain state to be their domicile (e.g., by speaking convincingly of their intent to make the state their domicile). [See IV.A. above.]

V. STATE TAXATION OF REAL AND PERSONAL PROPERTY

A. Ad valorem tax: "A tax imposed proportionally on the value of something (esp. real property), rather than on its quantity or some other measure." Black's Law Dictionary (10th ed. 2014).

B. The taxation of real property is not affected by Section 4001, because real property is taxed where it sits.

C. Ad valorem taxation of personal property.

1. Normally, actual physical situs controls.

2. The service member's personal property.

a. A service member's solely owned personal property, however, is deemed to be located in the service member's state of domicile, and only the state of domicile can tax it. 50 U.S.C. § 4001(d).

(1) *United States v. Arlington Cty., Va.*, 326 F.2d 929 (4th Cir.1964) – Naval officer, who was domiciliary of New Jersey and stationed in Virginia, could not be taxed on personal property left in Virginia while on sea duty.

(2) Virginia Attorney General Opinion – jointly titled vehicles of nonresident service members and nonmilitary spouses not subject to personal property tax in Virginia. Op. Va. Att'y Gen. No. 09-77, 2009 Va. AG LEXIS 49 (Nov. 16, 2009).

b. The service member is absolutely immune from taxation of nonbusiness personal property by the host state regardless of whether the service member pays personal property tax on the property to the state of domicile. *But see Sullivan v. United States*, 395 U.S. 169 (1969) (only annually recurring taxes on property impermissible; sales, use, and excise taxes are permissible).

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

(2) Use Tax. *See Re: Section 58.1-1821 Application Retail Sales and Use Tax*, 1994 Va. Tax LEXIS 275 (Va. Tax Comm. 1994) (service member who was stationed in Virginia and who purchased furniture in North Carolina without sales tax was subject to Virginia use tax on purchase). *See also* VA Stat. § 58.1-603 & 604 (imposition of sales and use taxes).

c. The Section 4001 protection for a service member's personal property does not apply to property used by the service member for business or income-producing purposes. With respect to such property, situs controls.

3. Personal property solely owned by the service member's spouse.

a. Generally, the traditional rule of situs controls.

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

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

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

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

c. State taxation schemes.

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

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

(3) A few states tax the property at full value. *See* 1976-1977 Op. Atty Gen. Va. 285, 1976 Va. AG LEXIS 129 (Oct. 14, 1976); 1986 Ariz. Op. Atty Gen. 111, No. I86-092 (R86-008), 1986 Ariz. AG LEXIS 37 (Aug. 25, 1986).

(4) Some do not try to tax it at all: *See* Mississippi Attorney Gen. Opinion, Feb. 27, 1989 – ad valorem taxes may not be levied on autos owned jointly by military and non-military spouses. 1989 Miss. AG LEXIS 138.

VI. MOTOR VEHICLES

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

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

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

B. Motor vehicle fees - conditional immunity.

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

a. *Sullivan v. United States*, 395 U.S. 169 (1969). Section 4001 (predecessor provision) protects from annually recurring property taxes; use or excise tax is permissible.

b. *California v. Buzard*, 382 U.S. 386 (1966). State barred from exacting a license fee based on percentage of auto's value.

California's two percent tax not essential to registration and licensing vehicle.

c. *United States v. City of Highwood*, 712 F. Supp. 138 (N.D. Ill. 1989). SSCRA exempted nonresident service members from annual revenue-raising vehicle fees of host state, but not from licensing, fees, or excises essential to functioning and administration of licensing and registration laws. *See also* Matter of Karsten, 924 P.2d 1272 (Kan. Ct. App. 1996).

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

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

C. House trailers and mobile homes.

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

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

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

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

d. *United States v. Chester Cty. Bd. of Assess. & Rev. of Taxes*, 281 F. Supp. 1001 (E.D. Pa. 1968) (nonresident service members'

house trailers not permanently affixed to ground were personal property exempt by SSCRA).

e. *Arizona Attorney General Opinion*, Aug. 25, 1986. Whether mobile home is real or personal property for purposes of SSCRA is question of federal law. It is personal if it retains characteristics of mobility. No. I86-092 (R86-008), 1986 Ariz. AG LEXIS 37.

f. *Virginia Attorney General Opinion*, Mar. 1, 1982. Nonresident military member exempt from personal property tax on mobile home, though real estate upon which it sits is taxable by host state. 1981-1982 Op. Atty. Gen. Va. 370, 1982 Va. AG LEXIS 269.

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

VII. STATE INCOME TAXATION SCHEMES

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

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

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

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

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

B. The states vary after this

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

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

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

C. State Income Tax Rates Vary Greatly.

D. Joint returns.

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

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

VIII. CONCLUSION

APPENDIX A

WHAT IS THE DEFINITION OF "LEGAL RESIDENCE"?

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

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

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

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

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

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

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

You normally cannot have your cake and eat it too.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

APPENDIX B

STATE OF LEGAL RESIDENCE CERTIFICATE

DATA REQUIRED BY THE PRIVACY ACT OF 1974

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

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

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

INSTRUCTIONS FOR CERTIFICATION OF STATE OF LEGAL RESIDENCE

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

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

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

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

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

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

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

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

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

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

APPENDIX C

WRITTEN BEFORE THE MSRRA WAS ENACTED

(Cite as: 1997-AUG Army Law. 24)

Army Lawyer
August, 1997

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

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

Lieutenant Colonel Conrad

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

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

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

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

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

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

FN58. SSCRA § 514.

FN59. Id.

FN60. Dameron v. Brodhead, 345 U.S. 322 (1953).
FN61. SSCRA § 514. This section provides no statutory protection against multiple state taxation of the income and

personal property of nonmilitary spouses. But cf. SSCRA § 536 (explicitly setting forth SSCRA protections that apply to nonresident military spouses as to leases, mortgages, and contracts); Brunson v. Chamberlina, 53 N.Y.S.2d 172 (N.Y. Mun. Ct. 1945); Wanner v. Glen Ellen Corporation, 373 F. Supp. 983 (D. Vt. 1974). See also 1986 Op. Ariz. Att'y Gen. 111 (1986); Op. S.C. Att'y Gen. 3000 (1970); 1984-85 Op. Va. Att'y Gen. 363 (1984); 1976-77 Op. Va. Att'y Gen. 285 (1976).

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

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

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

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

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

APPENDIX D

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2006 Army Law. 27

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

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

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

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

At first glance, Senior Chief Carr's connections and associations with Oregon appear to be no different from the actions of thousands of servicemembers throughout the U.S. armed forces with regard to their host (duty) states. It is common for Soldiers, Sailors, Airmen, and Marines to purchase homes and register vehicles in their state of military assignment, but these

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

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

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

FOOTNOTES:

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

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

(a) Residence or domicile. A servicemember shall neither lose nor acquire a residence or domicile for purposes of taxation with respect to the person, personal property, or income of the servicemember by reason of being absent

or present in any tax jurisdiction of the United States solely in compliance with military orders.

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

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

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

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

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

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

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

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

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

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

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

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

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

n15 *Id.* at *1.

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

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

n18 *Id.* at *5.

n19 *Id.*

n20 *Id.*

n21 *Id.* at *6.

n22 *Id.*

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

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

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

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

APPENDIX E

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

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

Major Samuel W. Kan [FNa1]

2. State Income Tax

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

a. Military Pay

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

To establish and maintain domicile, servicemembers must take specific steps to demonstrate their intent to make a state their permanent home rather than engaging in subterfuge to avoid paying state income tax. [FN48] First, after establishing physical presence in the state,

servicemembers should visit their local finance office and fill out appropriate paperwork, such as the DD Form 2058, *State of Legal Residence Certificate*. [FN49] Second, servicemembers should establish as many ties as possible to the state, such as registering to vote, purchasing real property, and obtaining professional and driver's licenses within the state. Third, servicemembers should express their desire to make the state their permanent home by telling others, such as friends and family, about their intent.

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

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

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

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

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

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

Appendix E

State Income Tax (A Quick Reference Guide)

STATE	MILITARY PAY EXCLUDED?	MIL. RETIREMENT PAY EXCLUDED?	CITATION
Alabama	No	Yes	ALA. CODE § 40-18-3 (LexisNexis 2009), ALA. CODE § 40-18-20 (LexisNexis 2009)
Alaska	No State Income Tax	No State Income Tax	ALASKA STAT. § 43.20.010 (2009)
Arizona	Yes[286]	Partial[287]	ARIZ. REV. STAT. § 43-1022 (LexisNexis 2008)
Arkansas	Partial[288]	Partial[289]	ARK. CODE ANN. § 26-51-306 (2008), ARK. CODE ANN. 26-51-307 (2008)
California	Yes[290]	No	CAL. REV. & TAX. CODE § 17140.5 (Deering 2009)
Colorado	No[291]	Partial[292]	COLO. REV. STAT. § 39-22-103 (2008), COLO. REV. STAT. § 39-22-112 (2008), COLO. REV. STAT. § 39-22-104 (2008)
Connecticut	Yes[293]	No	CONN. GEN. STAT. § 12-701 (2008)
Delaware	No	Partial[294]	DEL. CODE ANN. tit. 30, § 1121 (2009), DEL. CODE ANN. tit. 30, § 1106 (2009)
Florida	No State Income Tax	No State Income Tax	FLA. STAT. ANN. *§ 220.02 (LexisNexis 2009)*
Georgia	No	Partial[295]	GA. CODE ANN. § 48-7-27 (2009)
Hawaii	No	Yes	HAW. REV. STAT. § 235-2.3 (2009); HAW. REV. STAT. § 235-7 (2009)

STATE	MILITARY PAY EXCLUDED?	MIL. RETIREMENT PAY EXCLUDED?	CITATION
Idaho	Yes[296]	Partial[297]	IDAHO CODE ANN. § 63-3013 (2008), IDAHO CODE ANN. §63-3022A (2008)
Illinois	Yes	Yes	35 ILL. COMP. STAT. ANN. 5/203 (LexisNexis 2009)
Indiana	No	Partial	IND. CODE ANN. § 6-3-2-1 (LexisNexis 2009), IND. CODE ANN. § 6-3-2-3.7 (LexisNexis 2009)
Iowa	No	Partial	IOWA CODE § 422.9 (2008)
Kansas	No	Yes	KAN. STAT. ANN. § 79-32, 117 (2008)
Kentucky	Yes[298]	Partial	Joe Biesk, *Income Tax Exemption to Benefit Military Personnel*, DAILY INDEP., July 3, 2009, KY. REV. STAT. ANN. § 141.021 (LexisNexis 2009)
Louisiana	Partial[299]	Yes	LA. REV. STAT. ANN. § 47:293 (2009), LA. REV. STAT. ANN. § 47:44.2 (2009)
Maine	No	Partial[300]	ME. REV. STAT. ANN. tit. 36, § 5122 (2009)
Maryland	No	Partial[301]	MD. CODE ANN., TAX-GEN. § 10-207 (2009)
Massachusetts	No	Yes	MASS. ANN. LAWS ch. 62, § 2 (LexisNexis 2009)
Michigan	Yes	Yes	MICH. COMP. LAWS SERV. § 206.30 (LexisNexis 2009)
Minnesota	Yes[302]	No	MINN. STAT. § 290.01 (2008)
Mississippi	No	Yes	MISS. CODE ANN. § 27-7-15 (2008)

STATE	MILITARY PAY EXCLUDED?	MIL. RETIREMENT PAY EXCLUDED?	CITATION
Missouri	Yes[303]	Partial[304]	MO. REV. STAT. § 143.041 (2009), MO. REV. STAT. § 143.123 (2009)
Montana	No	Partial[305]	MONT. ADMIN. R. 42.15.219 (2009)
Nebraska	No	No	NEB. REV. STAT. ANN. § 77-2716 (LexisNexis 2009), NEBRASKA DEPT. OF REVENUE, NEBRASKA INCOME TAX FOR MILITARY SERVICE MEMBERS AND CIVILIANS WORKING WITH U.S. FORCES IN COMBAT ZONES 1 (2009), *available at* http://www.revenue.ne.gov/info/8-364.pdf. (last visited Jul. 20, 2009)
Nevada	No State Income Tax	No State Income Tax	Nevada Dept. of Taxation, *available at* http://tax.state.nv.us (last visited Jul. 20, 2009).
New Hampshire	No State Income Tax	No State Income Tax	New Hampshire Dept. of Revenue Administration Taxpayer Assistance, *available at* http://www.nh.gov/revenue/faq/gti-rev.htm (last visited Jul. 20, 2009).
New Jersey	Yes	Yes	N.J. REV. STAT. § 54A:6-26 (2009)
New Mexico	No	No	N.M. ADMIN. CODE § 3.3.4.1-12 (2009), N.M. ADMIN. CODE § 3.3.11.13 (2009)
New York	Yes[306]	Yes	N.Y. TAX LAW § 605 (Consol. 2009), N.Y. TAX LAW § 612 (Consol. 2009)
North Carolina	No	Partial[307]	N.C. GEN. STAT. § 105-134.6 (2009)

STATE	MILITARY PAY EXCLUDED?	MIL. RETIREMENT PAY EXCLUDED?	CITATION
North Dakota	Partial[308]	Partial[309]	CORY FONG, TAX COMMISSIONER, INCOME TAX TREATMENT OF MILITARY PERSONNEL 5 (n.d.), *available at* http://www.nd.gov/tax/indincome/pubs/guide/gl-28243.pdf (last visited Feb. 4, 2010)
Ohio	Yes[310]	Yes[311]	OHIO REV. CODE ANN. § 5747.01 (24) (LexisNexis 2009); OHIO REV. CODE ANN. § 5747.01(26) (LexisNexis 2009)
Oklahoma	Yes[312]	Partial	S.B. 881, 52nd Legis. Sess., 1st Sess. (Okla. 2009); OKLA. STAT. tit. 68, § 2358 (2009)
Oregon	Partial	Partial	OR. REV. STAT. § 316.791 (2007), Oregon Department of Revenue, Military Personnel Filing Information 150-101-657 (Rev. Jan. 2010), *available at* http://egov.oregon.gov/DOR/PERTAX/docs/101-657.pdf (last visited Feb. 22, 2010)
Pennsylvania	Partial	Yes	72 PA. CONS. STAT. § 3402-303 (2009), Pennsylvania Department of Revenue, PA-40 Pennsylvania Personal Income Tax Return 2009, *available at* http://www.portal.state.pa.us/portal/server.pt/community/personal_income_tax/14692 (last visited Feb. 22, 2010)
Rhode Island	No	No	R.I. GEN. LAWS § 44-30-2.6 (2009)
South Carolina	No	Partial[313]	S.C. CODE ANN. § 12-6-1170 (2008)
South Dakota	No State Income Tax	No State Income Tax	South Dakota Department of Revenue & Regulation, http://www.state.sd.us/drr2 (last visited Jul. 20, 2009)

STATE	MILITARY PAY EXCLUDED?	MIL. RETIREMENT PAY EXCLUDED?	CITATION
Tennessee	No State Income Tax	No State Income Tax	Tennessee Dept. of Revenue Frequently Asked Questions, *available at* http://www.tennessee.gov/revenue/faqs/indincome.htm#3 (last visited Jul. 20, 2009)
Texas	No State Income Tax	No State Income Tax	Comptroller of Public Accounts Windows on State Government, *available at* http://www.window.state.tx.us/taxes/ (last visited Jul. 20, 2009)
Utah	No	No[314]	UTAH CODE ANN. § 59-10-1019 (2009)
Vermont	Partial	No[315]	VT. STAT. ANN. tit. 32, § 5823 (2009), VT. STAT. ANN. tit. 32, § 5824 (2009)
Virginia	Partial[316]	Partial[317]	VA. CODE ANN. § 58.1-322 (2009)
Washington	No State Income Tax	No State Income Tax	Dept. of Revenue Income Tax, *available at* http://dor.wa.gov/content/FindTaxesAndRates/IncomeTax/ (last visited Jul. 20, 2009)
West Virginia	Yes[318]	Partial[319]	W. VA. CODE § 11-21-7 (2009), W. VA. CODE § 11-21-12 (2009)
Wisconsin	No	Yes	WIS. STAT. § 71.05 (2008)
Wyoming	No State Income Tax	No State Income Tax	Wyoming Dept. of Revenue, *available at* http://revenue.state.wy.us/ (last visited Jul. 20, 2009)

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Kelly, my summer intern research assistant who wrote Appendices E, F, and G, and CPT Evan Seamone, CPT Ronald Alcala, and Mr. Chuck Strong, the editors of the *Military Law Review* and *The Army Lawyer*.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Id.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[FN311]. *Id.*

Deduct, to the extent not otherwise deducted or excluded in computing federal or Ohio adjusted gross income for the taxable year, amounts received by the taxpayer as retired military personnel pay for service in the United States Army, Navy, Air Force, Coast Guard, or Marine Corps or reserve components thereof, or the national guard, or received by the surviving spouse or former spouse of such a taxpayer under the survivor benefit plan on account of such a taxpayer's death.

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

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

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

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

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

$15,000 and shall be reduced to zero if such military basic pay amount is equal to or exceeds $30,000.").

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

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

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

APPENDIX F

INFORMATION PAPER

DAJA-LA
11 January 2019

SUBJECT: 2018 Amendments to the Servicemembers Civil Relief Act (SCRA)

1. Purpose. To provide information on recent SCRA amendments.

2. Discussion. On 31 December 2018, The Veterans Benefits and Transitions Act of 2018 (VBTA), Pub. L. No. 115-407, was signed by the President. This statute contains four amendments to the SCRA (Title 50, United States Code (U.S.C.), Chapter 50).

a. Termination of Residential Leases of Deceased Servicemembers.

(1) Section 3955 of the SCRA allows Servicemembers to terminate residential and motor vehicle leases upon entering military service, or in connection with Permanent Change of Station (PCS) or certain military deployment orders.

(2) Section 301 of the VBTA extends the benefits of this provision in part to spouses of Servicemembers who die on active duty. The spouse may terminate a residential lease within one year of the Servicemember's death as long as the Servicemember died while in military service or while performing full-time National Guard duty, active Guard and Reserve duty, or inactive-duty training (as defined in 10 U.S.C. 101(d)).

(3) This provision applies to residential leases only and not to vehicle leases.

b. Termination of Multichannel Video Programming and Internet Access Contracts.

(1) Section 3956 of the SCRA allows Servicemembers to terminate cellular or landline telephone contracts upon receipt of military orders to relocate for 90 days or more to a place that does not support the contract.

(2) Section 304 of the VBTA extends this right of termination to internet service and multichannel video programming contracts.

(3) The amendment defines "multichannel video programming service" by referring to 47 U.S.C. 522. The Federal Communications Commission (FCC) currently interprets this definition to include cable and satellite TV providers (e.g. Comcast, Verizon Fios, Direct TV), but not online-only services such as Hulu and Netflix.[1]

[1] *See* 47 CFR 76.71. In 2015 the FCC issued a notice of proposed rule change that would have included Online Video Distributors (OVDs) in the definition of Multichannel Video Programming Distributors

(3) Section 302 of the VBTA fixes the "same state rule" problem for military Families with split legal residences. The same state rule remains, but now spouses can simply elect to have the same residence for state and local tax purposes as the Servicemember. Following an election, the factors previously used to determine the spouse's legal residence—such as the spouse's physical presence in a particular state or the identity of the state in which the spouse maintains a driver's license, vehicle or voter registrations, or professional licenses—are no longer relevant. In other words, if a Servicemember is a legal resident of a particular state for tax purposes, the spouse can unilaterally elect to also be a resident of that same state.

(4) The VBTA was signed on 31 December 2018—the last day of taxable year 2018. Accordingly, pursuant to Section 302(b), spouses can make this election for state and local returns for taxable year 2018 filed in the 2019 income tax filing season.

> Example: A Florida-domiciled Soldier marries a person domiciled in North Carolina while stationed at Fort Bragg in 2016. In 2017 the couple move to Virginia in compliance with PCS orders assigning the Soldier to Fort Lee, where the spouse obtains new employment. The spouse files a 2017 Virginia income tax return because, during that year, the couple did not share the same state of legal residence or domicile and therefore could not invoke the MSRRA. During the 2019 tax filing season, however, the spouse elects to have the same residence of the Soldier for tax purposes under Section 302 of the VBTA. The MSRRA/SCRA applies and the spouse's wages and other income are no longer taxable by Virginia.

d. Residence of Spouses of Servicemembers for Voting.

(1) Section 4025 of the SCRA was also amended by the MSRRA in 2009. It allowed spouses domiciled in the same state as the Servicemember to retain their residence for voting purposes. Much like MSRRA's tax provisions, the "same state rule" prevented MSRRA's voting provisions from providing relief to many military spouses.

(2) Section 303 of the VBTA amends Section 4025(b) of the SCRA by providing that spouses may also elect to have the same residence as the Servicemember for voting purposes.

(3) This amendment becomes effective 90 days after the date of enactment, or 31 March 2019.

4. For further information regarding the VBTA amendments to the SCRA/MSRRA, contact your servicing Legal Assistance Office.

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CHAPTER H

TAX ASPECTS OF STOCKS AND MUTUAL FUNDS

TABLE OF CONTENTS

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

I. REFERENCES

A. Internal Revenue Code (I.R.C.), §§ 1001-1016, 1221-1223.

B. Federal Income Tax Regulations (Treas. Reg.).

C. IRS Publications:

1. Pub. 17, Your Federal Income Tax Guide.

2. Pub. 544, Sales and Other Dispositions of Assets.

3. Pub. 550, Investment Income and Expenses.

4. Pub. 551, Basis of Assets.

D. IRS Forms and Instructions: 1040, Schedules A, B, D; 8949; 1099-B; 1099-DIV.

II. DIVIDENDS

A. Dividends. I.R.C. § 61(a)(7); Treas. Reg. § 1.61-9; Pub. 550; Form 1040, Schedule B, Part II.

1. Dividends are taxable distributions to a shareholder with respect to his or her ownership of stock in a corporation. I.R.C. § 301(c)(1), 316(a).

2. Payors of dividends are required to report them to the taxpayer and the IRS on Form 1099-DIV. I.R.C. § 6042(a), Treas. Reg. § 1.6042-2(a).

a. If over $1,500 or in other specified circumstances, the taxpayer must list each payor on Form 1040, Schedule B, Part II.

b. Certain credit unions, mutual savings banks, and similar institutions pay "dividends" that in fact represent interest. Both

these payors and the taxpayer should report such amounts as interest income. However, money market funds generally pay dividends that the taxpayer should report as such.

3. The taxability of corporate distributions Dividend means any distribution of money or property made by a corporation to its shareholders out of its earnings and profits. I.R.C. § 316(a); Treas. Reg. § 1.316-1(a).

4. How Dividends Are Taxed to Shareholders

   a. Dividends received before 2003 were taxed as ordinary income to the shareholder in the year they were actually or constructively received.

   b. Qualified dividends received after 2002 are taxed to shareholders at the rates that apply to net capital gains (i.e., 0%, 15%, 20%) if they constitute "qualified dividend income" paid to noncorporate shareholders (I.R.C § 1(h)(11)); otherwise, they are taxed at ordinary income rates to the extent the distributing corporation has earnings and profits. I.R.C. § 301(c)(1).

   c. The part of a distribution in excess of earnings and profits is treated as a tax-free return of capital and is applied against (reduces) the shareholder's basis in the stock. I.R.C. § 301(c)(2).

   d. Any remaining excess (once basis is reduced to zero) is treated as payment for the stock, i.e., as capital gain if the stock is a capital asset in the shareholder's hands. I.R.C. § 301(c)(3).

5. Types of dividends. I.R.C. § 301(a)-(b).

   a. Ordinary dividends. Domestic corporations, cooperatives, insurance companies, real estate investment trusts, and loan associations pay these on capital stock. I.R.C. §§ 316, 317, 318.

b. Qualified dividend income.

(1) For dividends received after 2002, qualified dividend income is dividend income received from domestic corporations and qualified foreign corporations (U.S. possession corporations and corporations eligible for benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program, but not foreign personal holding companies, foreign investment companies, or passive foreign investment companies. I.R.C § 1(h)(11)(B)(i).

(2) Dividends paid by other foreign corporations also are qualified if paid on stock or American Depositary Receipts (ADRs) readily tradable on an established U.S. securities market. I.R.C. § 1(h)(11)(C).

(3) Qualified dividend income does not include the following (some of these dividends may be reported in Box 1b of Form 1099-DIV):

(a) Dividends paid on stock unless the stock has been held for more than 61 days during the 121-day period beginning 60 days before the ex-dividend date (more than 91 days during the 181-day period beginning 90 days before the ex-dividend date for preferred stock dividends attributable to a period of more than 366 days). I.R.C. § 1(h)(11)(B)(iii)(I).

(b) Dividends on stock to the extent that the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property. I.R.C. § 1(h)(11)(B)(iii)(II).

(c) Any amount that the taxpayer elects to treat as investment income to support an investment interest deduction. I.R.C § 1(h)(11)(D)(i).

(d) Dividends from corporations that for the distribution year or the preceding year are exempt from tax under I.R.C. §§ 501 or 512 (tax exempt organizations and exempt farmers' cooperatives, respectively). I.R.C. § 1(h)(11)(B)(ii)(I).

(e) Dividends deductible under I.R.C. § 591 by mutual savings banks. I.R.C. § 1(h)(11)(B)(ii)(II).

(f) Dividends paid on employer securities owned by an employee stock ownership plan (ESOP), which are deductible under I.R.C. § 404(k). I.R.C. § 1(h)(11)(B)(ii)(III).

(4) Qualified dividend income does not include payments in lieu of dividends (typically made to owners of stock that has been lent in connection with a short sale), but only if the taxpayer knows, or has reason to know, that the payments are not qualified dividend payments.

(5) If an individual receives extraordinary dividends (within the meaning of I.R.C § 1059(c)) that are qualified dividend income, any loss on the dividend-paying stock is a long-term capital loss to the extent of the extraordinary dividends. I.R.C. § 1(h)(11)(D)(ii).

c. Noncash and other dividends. A distribution of property or a sale of property for less than its fair market value by a corporation to a shareholder may be a taxable dividend. I.R.C. §§ 316, 317, 318.

B. Insurance policy dividends. Dividends paid on a life insurance policy are usually not taxable. They are rebates of premiums paid. I.R.C. §§ 72(e)(2)(B) & (e)(3)(B).

C. Less common exclusions.

1. Qualified dividends exclude dividends: (*i*) paid to a taxpayer who "is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property [I.R.C. § 1(h)(11)(B)(iii)(II)]; (*ii*) paid by a tax-exempt organization or farmer's cooperative [I.R.C. §§ Section 1(h)(11)(B)(ii)(I), 501, 521]; (*iii*) paid by mutual savings banks and similar organizations (this is interest income) [I.R.C. §§ 1(h)(11)(B)(ii)(II), 591]; (*iv*) paid on employer securities held by an employee stock ownership plan (ESOP) [I.R.C. §§ 1(h)(11)(B)(ii)(III), 404(k)]; and (*v*) that the taxpayer elects to treat as investment income to clam the investment expense deduction [I.R.C. § 1(h)(11)(D)(i)].

2. Other exclusions relate to passive foreign investment companies and extraordinary dividends, which are beyond the scope of this Deskbook.

a. Holding period requirement. Qualified dividends do not include dividends paid on stock unless the stock has been held for at least 61 days in the 121-day period beginning 60 days before the "ex-dividend date." I.R.C. §§ 1(h)(11)(B)(iii)(I), 246(c).

(1) In counting days, the taxpayer includes the day of disposal, but excludes the day of acquisition. I.R.C. § 246(c)(3)(A).

(2) Corporations announce dividends to shareholders of record as of a particular date, the "record date." The "ex-dividend" date is normally one business day beforehand. A purchaser of stock on or after the ex-dividend date does <u>not</u> receive the announced dividend (the stock price will reflect this).

(3) The taxpayer's days of ownership do not need to be consecutive.

III. CAPITAL ASSETS

A. Defined: any asset held whether connected with a trade or business except:

1. Inventory held in the ordinary course of business.

2. Depreciable property used in trade or business.

3. Property held primarily for sale to customers in ordinary course of business.

4. Copyrights, literary or musical compositions, memorandums.

5. Accounts receivable acquired in the ordinary course of business.

B. Examples. Almost everything the taxpayer owns is a capital asset, including:

1. Investment property (e.g., mutual fund shares, stocks, bonds).

2. Property held for personal use, such as a personal residence, jewelry, automobile used for pleasure or commuting, coin or stamp collections.

C. Favorable rates of 0%, 15%, and 20% apply to taxable gains (other than collectibles and real estate depreciation recapture). Before 2018, these rates applied based on the character and amount of the taxpayer's other income. I.R.C. § 1(h). For years 2018 through 2025, these rates are applied at the

based on independent tax brackets. I.R.C. §1(h)(1), (j)(5). See the Instructions to Form 1040, Qualified Dividends and Capital Gain Worksheet.

D. Capital gains and losses are reported on Form 8949 and Schedule D.

E. The maximum capital gains rate for collectibles is 28% and for real estate depreciation recapture is 25%.

F. Capital Gains Distributions.

1. Paid out of the net long-term capital gains of a corporation. Typically come from mutual funds, investment companies, or real estate trusts.

2. Capital gains distributions are reported to taxpayers on Form 1099-DIV, and by the taxpayer on Schedule D, line 13. The taxpayer then completes Schedule D to compute the net long-term capital gains or losses, and then computes the back of the schedule to determine the maximum capital gains tax.

3. If the only amount a taxpayer has to report on a Schedule D is a capital gain distribution, the taxpayer may be able to report that amount directly on Form 1040, line 13.

4. The 1099-DIV identifies in block 2a the total capital gain distributions.

G. Losses from the sale or exchange of assets held for personal pleasure are not deductible unless the loss resulted from a theft or casualty, in which case they may be deductible as ordinary losses. IRC § 165(c).

IV. BASIS

A. Cost Basis. Usually basis is property's cost, including:

1. Amount of cash, and the fair market value of property or services exchanged;

2. Amount of debt, mortgage, or liability assumed; and

3. Purchase fees and closing costs (I.R.C. § 1012).

B. Other Basis.

1. Fair Market Value. The price at which a willing seller would sell and a willing buyer would pay for a piece of property, both acting at arms length, with full knowledge of the facts involved, and neither being under any compulsion to sell or buy.

2. Basis of gifts. I.R.C. § 1015.

a. General rule: carryover basis.

b. Exception: Basis is fair market value (FMV) <u>if</u> basis is greater than FMV at time gift made <u>and</u> there is a loss on the sale of the property later by the donee. This exception applies only if donor's basis is greater than FMV when gift made <u>and</u> donee's subsequent sale price is less than both donor's basis and FMV when gift made.

3. Inherited property. I.R.C. § 1014. Fair market value at date of decedent's death or alternate valuation date. This step-up in basis is one of the few times in the Internal Revenue Code where built-in gains escape taxation altogether. the total gain.

C. Adjusted Basis. I.R.C. § 1016.

1. The basis of property must be increased or decreased to reflect certain transactions. Events after purchase can necessitate adjustments to basis.

2. The term adjusted basis refers to the basis after changes are made.

3. Common basis increases:

a. Capital expenditures/improvements (having a useful life of more than one year) add to the value of property, lengthen its life, or adapt it to a different use (e.g., adding a room to a home).

b. Contributions to capital.

c. Assessments paid for local improvements.

4. Common basis decreases:

a. Partial losses due to theft or casualty. (Decreased by the amount of insurance or reimbursements received and the amount of deductible loss.) I.R.C. § 165(h).

b. Depreciation. Basis is reduced by the larger of the:

(1) amount claimed, or

(2) amount allowed. I.R.C. § 1016(a)(2).

5. For example, when a stock dividend or stock split is declared, the stockholder receives additional shares of stock. Some of the basis from the original stock is then allocated to the new stock. This change reduces the basis per share of the original shares.

6. The adjusted basis of a stock is usually its cost plus any brokers' commissions.

V. DETERMINING CAPITAL GAIN OR LOSS

A. General Rule.

1. The gain or loss from a sale or other disposition of property is measured by the difference between the amount realized and the

adjusted basis of property sold or exchanged. I.R.C. § 1001; Treas. Reg. § 1.1001-1.

2. The amount realized is the total of all money received, the fair market value of property or services received, plus any liabilities assumed by the buyer.

3. Gain from the sale or exchange of property is included in income and taxed at ordinary income tax rates, subject to certain maximum capital gains rates.

4. Report capital gains and losses on Schedule D, Form 1040.

B. Holding Period.

1. Whether gains or losses from the sale or exchange of capital assets are short-term or long-term depends on the period of time the capital assets were held.

a. Short-term is twelve months or less;

b. Long-term is over twelve months.

2. Records should show acquisition and disposition dates.

a. Exclude date property was acquired but include date it was disposed.

b. Day after property was acquired is start of holding period and this same date in succeeding calendar months is start of new month.

3. Stock splits and stock dividends:

a. Stock acquired in a tax-free stock dividend or stock split has the same holding period as the original stock owned.

b. If the original stock has a long-term holding period, stock received in a tax-free stock dividend also has a long-term holding period. Net Capital Gains and Losses (Computing Capital Gains).

4. Short-term capital gain and loss means gain or loss from the sale or exchange of a capital asset held no more than 12 months.

5. Long-term capital gain and loss means gain or loss from the sale or exchange of a capital asset held more than 12 months.

6. Net capital loss is excess of all capital losses for the year over capital gains.

7. Net capital gain is the excess of net long-term capital gains over net short-term capital losses.

8. Determine whether any maximum tax rates apply.

C. Capital Losses.

1. Amount of loss deductible. A non-corporate taxpayer having capital losses may deduct those losses only to the extent of gains from the sale of capital assets plus the lower of:

a. $3,000 ($1,500 for married individuals filing separate returns), or

b. the excess of the losses over the gains (I.R.C. § 1211(b)).

2. Capital loss carryover. Losses in excess of the amounts deductible are carried over to the succeeding tax years indefinitely until absorbed. I.R.C. § 1212(b).

3. Carryover capital losses retain their character as long-term or short-term. Short-term losses must be used first.

D. Capital gains and losses. I.R.C. §§ 61(a)(3), 1001, 1011-1012, 1221-1222; IRS Forms 1040, Schedule D and 8949.

1. A taxpayer must include in gross income all "gains from dealings in property." I.R.C. § 61(a)(3).

2. A capital asset generally includes all assets held by a taxpayer for personal or investment use. Defined as any asset held whether connected with a trade or business except:

(a) Inventory held in the ordinary course of business. I.R.C. § 1221(a)(1).

(b) Depreciable property used in trade or business. I.R.C. § 1221(a)(2).

(c) Property held primarily for sale to customers in ordinary course of business. I.R.C. § 1221(a)(1).

(d) Copyrights, literary or musical compositions, memorandums. I.R.C. § 1221(a)(3).

(e) Accounts receivable acquired in the ordinary course of business. I.R.C. § 1221(a)(4).

(2) Examples. Almost everything the taxpayer owns is a capital asset, including:

(a) Investment property (e.g., mutual fund shares, stocks, bonds). I.R.C. § 1221(a).

(b) Property held for personal use, such as a personal residence, jewelry, automobile used for pleasure or commuting, coin or stamp collections. I.R.C. § 1221(a).

b. Significance of capital asset classification.

(1) The tax treatment of capital gains and losses depends on whether the gains and losses are long-term or short-term and on whether the taxpayer is a corporation or not.

(a) For noncorporate taxpayers, the maximum tax rate on net long-term capital gains is lower than the top rate on ordinary income.

(b) The maximum tax rate on long-term capital gains depends on the type of capital asset sold and the taxpayer's marginal tax rate (the top rate of tax on the person's ordinary income).

(c) The long-term capital gains of corporations are taxed at ordinary income tax rates and do not have a preferred tax rate. Similarly, short-term gains of corporations and of noncorporate taxpayers are taxed at the same rates as their ordinary income. The deduction for capital losses is limited, but unused capital losses may be carried over to the next tax year.

(2) Net Capital Gains and Losses. Short-term capital gains and losses are netted, long-term capital gains and losses are netted, and then the net long- and net short-term gains are netted with each other. Further netting may be required if the taxpayer has capital losses as well as long-term capital gain subject to differing maximum rates of tax.

(a) Definitions:

(i) Short-term capital gain. The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for one (1) year or less, if and to the extent such gain is taken into account in computing gross income. I.R.C. § 1222(1).

(ii) Short-term capital loss. The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for one (1) year or less, if and to the extent that such loss is taken into account in computing taxable income. I.R.C. § 1222(1).

(iii) Long-term capital gain. The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than one (1) year, if and to the extent such gain is taken into account in computing gross income. I.R.C. § 1222(3).

(iv) Long-term capital loss. The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than one (1) year, if and to the extent that such loss is taken into account in computing taxable income. I.R.C. § 1222(4).

(b) Netting:

(i) Short Term Gains and Losses are netted:

a. Short-term capital losses (including short-term capital loss carryovers) are netted against, or reduce, the total short-term capital gains, if any. The result is your net short-term capital gain or loss. Net short-term capital gains are taxable at ordinary income tax rates.

b. A net short-term capital loss is used to reduce any net long-term capital gains from the 28% tax group, then to reduce any net long-term gains from the 25% tax group, then to reduce any net long-term gains from the 20% tax group, and finally to reduce net long-term gains from the 15% group.

(ii) Long-Term Gains and Losses are netted:

a. Long-term capital gains and losses are similarly netted. Long-term capital gains and losses are first netted by category:

- Net section 1231 gain from Part I, Form 4797, after any adjustment for nonrecaptured section 1231 losses from prior tax years.
- Capital gain distributions from mutual funds and real estate investment trusts.
- Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
- Any long-term capital loss carryover

A net long-term capital loss from the 28% group (including long-term capital loss carryovers) is applied first to reduce any long-term gains from the 25% tax group, then to reduce any long-term gains from the 20% tax group, and then to reduce net long-term gains from the 15% group.

b. A net loss from the 15% group is applied first to reduce net gain from the 28% group, then to reduce gain from the 25% group.

(iii) Long- and short-term capital gains/losses are netted with each other. Any resulting net capital gain that is attributable to a particular rate group is taxed at that group's marginal tax rate. I.R.S. Notice 97-59, 1997-2 C.B. 309. If the result is a net capital loss, the difference is deductible. But

there are limits on how much of the loss can be deducted and when it can be deducted.

(3) Maximum capital gains tax rate. I.R.C. § 1(h), (j)(5). The maximum capital gains tax rate is 0%, 15%, or 20% depending on the taxpayer's income and the type of property at issue. Special rates of 25% for unrecaptured Section 1250 gain and 28% for collectibles (see below) still apply.

(a) An additional 3.8% surtax (net investment income tax) is imposed on the net investment income of taxpayers with modified AGI exceeding $200,000 for Single and HOH, $250,000 for Married Filing Joint and Qualified Widow(er), and $125,000 for Married Filing Separate. Treas. Reg. § 1.1411-2; *see generally* Treas. Reg. §§ 1.1411-1 – 1.1411-10; IRS Form 8960.

(b) 25% maximum rate applies to long-term capital gain attributable to real estate depreciation (unrecaptured section 1250 gain). I.R.C. § 1(h)(1)(E) & (h)(6).

(c) Under I.R.C. §1(h)(1)(F), the 28% maximum rate applies to:

(i) The long-term capital gain from collectibles (as defined by I.R.C. § 408(m), but without regard to I.R.C. § 408(m)(3) – i.e., works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages, I.R.C. § 1(h)(5)-(6); and

(ii) I.R.C. § 1202 gain (commonly referred to a 28% rate gain) – i.e., the excess of the gain on the sale or exchange of qualified small business stock held for more than five years that would be excluded from gross income under I.R.C. § 1202, but for the percentage limitation in I.R.C. § 1202(a), over the gain excluded from gross income under I.R.C. § 1202. I.R.C. § 1(h)(7).

(iii) The gain subject to the 28% maximum rate may be offset by net short-term capital losses for the taxable year and long-term capital loss carryovers from prior taxable years. I.R.C. § 1(h)(4).

c. Capital gains and losses are reported on Schedule D.

d. Capital Gains Distributions.

(1) Paid out of the net long-term capital gains of a corporation. Typically come from mutual funds, investment companies, or real estate trusts.

(2) Capital gains distributions are reported to taxpayers on Form 1099-DIV, and by the taxpayer on Schedule D. The taxpayer completes Schedule D to compute the net long-term capital gains or losses, and then computes the back of the schedule to determine the maximum capital gains tax.

(3) If the only amount a taxpayer has to report on a Schedule D is a capital gain distribution, as shown in box 2a of the Form 1099-DIV, then the taxpayer may be able to report that amount directly on Form 1040, page 2.

(4) Note, however, the taxpayer will still need to complete a worksheet to take advantage of lower maximum capital gains rates.

VI. BASIS OF STOCKS & BONDS

A. If possible, trace basis of stock or bond sold to original cost.

B. If tracing is not possible, the cost of the first lot bought is used as the basis for the first lot sold (FIFO). Treas. Reg. § 1.1012-1(c).

C. Distributions.

1. Ordinary dividends.

a. Paid out of earnings and profits.

b. Cash or stock.

c. Taxable in year paid.

2. Capital gain distributions.

a. Paid out of net long-term capital gains of company.

b. Reported as long-term capital gain on Schedule D or directly on Form 1040, line 13.

c. Mutual funds, investment companies, real estate trusts pay them.

3. Nontaxable distributions.

a. Not paid out of earnings.

b. Return of investment.

c. Reduces basis to zero, then reported as either a long- or short-term capital gain depending on holding period.

d. If stock dividend is identical to the held stock, then divide adjusted basis of old stock by the number of old and new stock shares. For example, T holds one share of voting common at $60. The corporation distributes a stock dividend of two new shares of voting common for each share held. T now has three shares of voting common with a basis of $20 each.

VII. MUTUAL FUNDS

A. Taxes.

1. Conduit for tax purposes.

2. Distributions (Form 1099-DIV).

a. Dividends.

(1) Total Ordinary Dividends—taxed at ordinary income rate

(2) Qualified Dividends—taxed at reduced 0%, 15%, or 20% rate depending on taxable income.

(a) Dividends received from a domestic corporation or a qualified foreign corporation (one that is incorporated in a US possession or is incorporated in a country that has a current tax treaty with the US and meets various other qualifications)

(b) Holding period: must have held the stock on which the dividends are paid for more than 60 days during the 120 day period that begins 60 days before the ex-dividend date. The ex-dividend date is the last date on which a shareholder of record is entitled to receive the upcoming dividend.

(c) The following "dividends" are **NOT** qualified dividends: dividends from a Section 501 corporation; insurance company dividends.

b. Capital gains.

(1) Total capital gain distributions

(2) Post-5 May 2003 capital gain distributions

3. Important dates.

a. Record date: date on which mutual fund determines which shareholders are entitled to distribution.

b. Trade date: date shares sold or exchanged.

4. Timing. Investing in a fund on or before a record date for a distribution results in liability for taxes on distribution.

B. Capital Gains and Losses.

1. Dispositions.

a. Share redemption.

b. Check writing.

c. Exchange of shares.

2. Form 1099-B, Proceeds From Broker and Barter Exchange Transactions.

a. Investment companies reports sales price to the IRS in box 2 of Form 1099-B.

b. Some brokers do not subtract commissions and fees; they report the gross sales proceeds as the sales price.

c. Other brokers do subtract commissions and fees, reporting the net sale proceeds as the sales price.

3. Since 2011, brokers have been required to track cost basis for stocks. In 2012, they must track basis also for mutual funds. Since 2013, basis for options and debt instruments must be tracked as well. See Form 1099-B.

4. Record Keeping. Necessary to establish gain/loss for tax purposes.

C. Reinvested Distributions. Mutual fund pays in the form of additional mutual fund shares.

1. Example. Suppose Taxpayer invested $10,000 in a fund over time. During the same period, the fund paid dividend and capital gains distributions of $800, which were reinvested in additional fund shares. The mutual fund properly reported these distributions to the taxpayer on Form 1099-DIV and the taxpayer reported them as current income. Assume taxpayer later sells all fund shares for $11,000. Some taxpayers err by reporting a $1,000 capital gain. In fact, the taxpayer's investment (basis) is really $10,800, yielding only $200 of gain.b

D. Basis in Mutual Funds.

1. Specific identification method. Cost basis is original purchase price of shares specified for sale. This method lets taxpayer choose the shares that provide the most desirable tax result.

2. Taxpayer can elect to use one of two averaging methods. Treas. Reg. § 1.1012-1(e).

a. Single-category method: all shares regardless of holding period grouped in one category and averaged.

b. Double-category method: all shares in respective holding category grouped and averaged in each group.

3. Shareholder who does not elect either method must use normal, first-in, first-out (FIFO) method for matching cost with shares sold.

E. Special Gain or Loss Situations.

1. Fees.

a. Load or "front-end" fees. Purchase fees some mutual funds impose. Reduce investment, but are still part of cost basis for tax purposes. For example, a $950 fund investment with a $50 load has a cost basis of $1,000.

b. Redemption fees. "Back-end fees" charged when taxpayer redeems shares in some funds. Usually expressed as percent of amount redeemed. Taxpayer will not have to adjust tax cost if mutual fund reports sales proceeds net of redemption fees on Form 1099-B (If mutual fund does not so report, taxpayer increases basis by amount of fee paid per share).

c. Custodial and account maintenance fees are commonly charged.

(1) Both are deductible as "investment expenses" on Schedule A.

(2) IRA custodial fee only deductible if paid by separate check, not if redeemed from IRA.

2. Capital losses and the "Wash Sale Rule."

a. Mutual fund wash sale rule: a capital loss is disallowed to the extent that the taxpayer purchased shares in the same fund within 30 days of (before and after) the sale. Rule designed to discourage short-term, loss-oriented selling.

(1) Avoid effect by not purchasing shares of a fund within 30 days before or after a loss realized.

b. Municipal bond fund losses. If taxpayer sells shares in a municipal bond fund as a loss and owned those shares for 6 months or less, the loss is disallowed to the extent that taxpayer received tax-exempt income from the same fund during that period.

c. Capital gains distributions and losses. If taxpayer holds shares in a mutual fund for 6 months or less, and during that period receives a capital gains distribution, then any capital loss realized from a sale of those shares is treated as a long-term capital loss to the extent of the capital gains distribution.

VIII. REPORTING GAIN OR LOSS ON SCHEDULE D

A. Capital gains and losses are reported on Form 1040, Schedule D and Form 8949.

1. Complete a separate Form 8949 for each category of sales

a. Category A: Short term gains or losses where block 3 of the 1099-B shows basis.

b. Category B: Short term gains or losses where block 3 of the 1099-B does not show basis.

c. Category C: Short term gains or losses where no 1099-B is received.

d. Same categories for Long term gains and losses are on part II of the Form 8949 and listed as Categories D, E, and F.

B. Figure the gain or loss by subtracting the adjusted basis of stock from its sales price. If the sales price is greater, the taxpayer has gain of the sale. If the adjusted basis is greater than the sales price, the taxpayer has a loss on the sale.

IX. CONCLUSION

CHAPTER I

TAX ASPECTS OF IRAs

TABLE OF CONTENTS

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

I. REFERENCES

A. Internal Revenue Code (I.R.C.), §§ 219, 408, 408A, 529, 530.

B. Federal Income Tax Regulations, §§ 1.408-1 to 1.408-11 and 1.408A-0 to 1.408A-9.

C. IRS Pubs. 590-A and 590-B, Individual Retirement Arrangements (IRAs).

D. IRS Forms and Instructions: 1040 (IRA Deduction Worksheet), 5329, 5498, 8606.

II. FUNDAMENTALS

A. Definition.

1. In general, an IRA is a trust or custodial account created or organized in the U.S. for the exclusive benefit of an individual or his or her beneficiaries. I.R.C. § 408(a); Treas. Reg. § 1.408-2(b).

a. Beneficiaries--the individual's estate, dependents, and any person he or she designates to share in the benefits of the account after death. Treas. Reg. § 1.408-2(b)(8).

b. IRAs are exempt from federal income tax unless the IRA is disqualified due to a prohibited transaction.

B. Characteristics.

1. Simple procedure for establishing personal retirement program.

2. Contributions to traditional IRAs are currently deductible, except by "active participants" in retirement plans who have adjusted gross income in excess of specified levels.

3. Earnings on traditional IRAs are not subject to federal income tax until distributed.

4. Roth contributions are not currently deductible. However, earnings are not subject to federal income tax upon qualified distributions.

C. Contribution Deadline. Normally the due date for the return (15 April without regard to extensions); however, the IRA need not actually be established until such due date in order to claim a contribution. I.R.C. § 219(f)(3).

1. Contribution may be deducted if it is mailed before the return due date, even if it is not received by the IRA custodian until after the due date.

2. Deduction may be claimed on return--even if contribution not yet made--so long as contribution actually occurs by due date.

3. The CZ/QHDA extension provides service members with an additional period in which to contribute to an IRA for a preceding tax year. I.R.C. § 219(f)(7).

a. To qualify, the service member must make a contribution before the earlier of the end of the income tax return filing period established under the CZ/QHDA tax extensions or the date on which the federal income tax return actually is filed. I.R.C. § 7508.

b. For example, a contribution made on June 1, 20X2, could be designated as a contribution for the 20X1 tax year if it is made before the taxpayer's CZ/QHDA suspension period expires. The taxpayer would have to designate the contribution as a contribution for the 20X1 tax year to claim it on that year's tax return. See also Pub. 3; IR 2006-129.

D. Prohibited Transactions.

1. Borrowing money from an IRA. The amount borrowed is treated as a distribution.

2. Selling property to an IRA.

3. Pledging an IRA account as security for a loan. The part of the account pledged as security is treated as a distribution.

III. WHO MAY PARTICIPATE?

A. Taxpayer must have earned compensation.

1. Includes wages, salaries, tips, bonuses, commissions, partnership, alimony, self-employment income, and other amounts for personal services. I.R.C. § 219(f).

2. Does not include passive income such as profits from property, i.e., rental income, interest, dividends, pensions, or annuities (including military retirement pay).

3. Compensation also does not include foreign earned income excluded from gross income.

B. Limits on IRA Contributions.

1. The maximum contribution is published annually by the IRS, based on a statutory amount of $5,000 adjusted for inflation . I.R.C. § 219(b)(5).

2. An individual age 50 or older can make an additional $1,000 “catch up” contribution. I.R.C. § 219 (b)(5). Catch up contributions are

permitted beginning in the year the individual turns 50 and every year thereafter.

3. There are special rules for certain married individuals, which allow for a spousal IRA. A spouse with no earned compensation or an amount less than the maximum contribution amount can participate in an IRA. I.R.C. § 219(c). These special rules for spouses will be discussed in detail later in the outline.

IV. LIMITS ON TRADITIONAL IRA DEDUCTIONS

A. A deduction in the maximum amount is allowed only if the taxpayer is not covered by employer-provided retirement plan and has earned income of at least that amount.

B. Limitations for Participants in Employer-Provided Retirement Plans for Traditional IRAs.

1. Deductibility of contributions is limited if the taxpayer is covered by an employer-provided retirement program.

a. An employee is considered covered regardless of whether benefits have vested.

2. Active duty service members are considered covered by an employer-provided retirement plan. I.R.C. § 219(g)(1); IRS Notice 87-16; *Morales-Caban v. Commissioner*, T.C. Memo. 1993-466 (active duty military covered by employer-provided plan).

3. Reservists on active duty for 90 days or less are not, by virtue of their reserve status, considered covered by an employer-provided plan. I.R.C. § 219(g)(6)(A).

C. Taxpayers with modified AGI less than an applicable amount (see Instructions to Form 1040) are permitted a full deduction. If the taxpayer's modified AGI

exceeds the applicable threshold for his or her filing status, the deduction is phased-out over a range until it is reduced to zero.

D. IRA deductions may be limited if the taxpayer is covered by an employer-provided retirement plan (e.g., service members).

1. Phaseout of deduction depends on income and filing status. I.R.C. § 219(g)(2)(A).

a. Deduction Phaseout. The deduction is reduced or eliminated entirely depending on the taxpayer's filing status and income.

b. Use the worksheet in the Form 1040 Instruction booklet to figure the amount, if any, of the taxpayer's IRA deduction.

2. Taxpayers may make nondeductible contributions to the extent a deduction is disallowed. Must be reported to the IRS on Form 8606.

E. Special rules for married taxpayers.

1. There are special rules for certain married individuals that allow a taxpayer with no earned compensation or amounts less than the maximum contribution amount to participate in an IRA. I.R.C. § 219(c). This section is not specifically for non-working spouses.

a. An individual who files a joint return and has less taxable compensation than his spouse may contribute to a spousal IRA and deduct the lesser of the maximum contribution, or the sum of that individual's includible compensation for that tax year, plus the includible compensation of the individual's spouse reduced by the spouse's allowable IRA deduction and Roth IRA contribution for that tax year. I.R.C. § 219(c), (f).

b. A spouse who is 50 or older can also make the catch-up contribution of an additional $1,000.

c. The practical application of this provision permits IRA contributions (and perhaps a deduction) of up to the maximum amount for each spouse (including a spouse with less than the maximum amount for the year) if their combined compensation income for the year equals or exceeds the contributed amount.

2. The phase-out limit is higher than the usual limit for an individual who is not an active participant in an employer plan during any part of the year, but whose spouse is an active plan participant. I.R.C. § 219(g)(7). For these individuals, the IRA deduction phase-out is based on a statutory amount of $150,000, adjusted for inflation.

F. Under I.R.C. § 219(f)(7), compensation for service in a combat zone is included as earned income.

G. Nondeductible Contributions.

1. An active participant in a qualified plan who may not be eligible to make contributions either whole or in part to an IRA can make designated nondeductible contributions to an IRA for a tax year up to the due date for the income tax return for that year. Taxpayers who have lost part or all of their IRA deduction because of the phaseout rules may make nondeductible contributions to the extent the deductible amount is disallowed. I.R.C. § 408(o).

2. None of the earnings on the contributions will be taxed until distributed.

3. A taxpayer may designate deductible contributions as nondeductible. Nondeductible and deductible contributions can be made to the same IRA. I.R.C. § 408(o)(2)(B)(ii).

4. Taxpayers must report nondeductible contributions on IRS Form 8606 to establish the taxpayer's basis in the account. Establishing the cost

basis is necessary to determine the proper taxation of distributions (see part VI. below).

a. Failure to file form is subject to a $50 fine, unless reasonable cause is shown.

b. Overstating nondeductible contributions carries $100 penalty, unless reasonable cause is shown.

5. A taxpayer making nondeductible contributions to a traditional IRA will have a cost basis in the IRA which is the sum of the nondeductible amounts that have been contributed less any distributions of those amounts.

H. Other Restrictions.

1. Before 2020, the maximum age to contribute to an IRA was age 70½. I.R.C. § 219(d)(1) (before repeal by Pub. L. No. 116-94, § 107, 133 Stat. 2534, 3148 (Dec. 20, 2019)).

2. No deduction is permitted for a rollover contribution nor for any contribution to an "inherited" IRA—one acquired by other than the surviving spouse as a result of the death of the participant. I.R.C. § 219(d)(2).

I. Excess Payments and Contributions. I.R.C. § 4973.

1. These rules apply to Traditional IRAs and Roth IRAs.

2. An excess payment is defined as any amount paid into an account by the taxpayer, spouse, or employer exceeding the maximum amount yearly amount.

3. Taxpayers must pay a 6% excise tax each year on the excess amount left in an account (unless withdrawn before the filing deadline).

4. Interest earned on excess payment generally must also be withdrawn and included in gross income, and is subject to a 10% tax for early withdrawal.

5. A taxpayer cannot reduce an excess payment by applying it against an earlier year in which less than the full amount was contributed. If contributed during the next year, the taxpayer can reduce the contribution by applying it against the next year, but the annual contribution limit may not be exceeded.

V. ROLLOVERS

A. General Rule. I.R.C. § 408(d)(3).

1. Taxpayers may withdraw part/all funds in one IRA account and transfer to another IRA account or qualified retirement plan within 60 days of withdrawal, without tax liability. I.R.C. § 402(c).

a. Amount withdrawn is not considered an early withdrawal.

b. The 60-day period is strictly construed. PLR 8824047 (Rollover into another IRA not tax free even though failure to meet 60 day period was not taxpayer's fault). PLR 9211035 (Clerical error did not save taxpayer from tax). *But see Wood v. Commissioner*, 93 T.C. 114 (1989) (Trustee bookkeeping mistake not held against taxpayer).

c. If the rollover is not completed within the 60-day period, it is treated as a taxable distribution.

d. The IRS may waive the 60-day rollover period if failure to waive would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.

2. In general, a taxpayer may make only one tax-free rollover from an IRA to another IRA in any 12-consecutive month period. I.R.C. § 408(d)(3)(B). If the taxpayer has more than one IRA, a separate one-year waiting period will apply to each IRA.

Example. Captain R has two IRAs (IRA #1 and IRA #2). He rolls over the assets of IRA #1 into new IRA #3. Within the 12-consecutive month period commencing on the date of the distribution from IRA #1, he may also make a tax-free rollover from IRA #2 into IRA #3 or into any other IRA. However, he may not again, within such 12-consecutive-month period, make a rollover from IRA #1. See Pub. 590-A.

3. Inherited IRAs.

a. A surviving spouse, who is the sole designated beneficiary, who receives her interest in the IRA pursuant to inheritance may roll over a distribution from that IRA to another IRA, or to a qualified retirement plan, without incurring tax liability. I.R.C. § 408(d)(3)(C).

b. A non-spouse beneficiary may not roll over post-death proceeds from an IRA. I.R.C. § 408(d)(3)(C).

(1) A non-spouse beneficiary, like the original owner, generally will not owe tax on the assets in the IRA until distributions from the IRA are received.

(2) There are special rules that apply to when non-spouse beneficiaries must withdraw IRA assets or take required distributions.

(3) If a taxpayer inherits a traditional IRA from a person who had a basis in an IRA because of nondeductible contributions, that basis remains with the IRA. If a taxpayer takes a distribution from an inherited IRA that has a basis, the taxpayer must complete a Form 8606 to

determine the taxable and nontaxable portions of the distributions.

4. The distribution from an IRA to a spouse or former spouse pursuant to a "qualified domestic relations order" may be rolled over tax-free to another IRA. However, if the alternate payee is not the IRA participant's spouse or former spouse, the distribution may not be rolled over. Specifically, the distribution to a non-spouse alternate payee is includible in the gross income of the IRA participant (I.R.C. § 402(e)(1)(B).

5. If an eligible rollover distribution is paid directly to the taxpayer, the payer must withhold 20% of it. This applies even if you plan to roll over the distribution to a traditional IRA. The taxpayer can avoid the withholding by choosing the direct rollover option.

6. Report rollovers (e.g., IRA distributions) on Form 1040.

B. Military Death and Servicemembers' Group Life Insurance (SGLI) Payments.

1. A recipient of a military death gratuity or SGLI proceeds can contribute the amounts received (reduced by any amounts contributed to a Coverdell education savings account) to a Roth IRA as a qualified rollover contributions. I.R.C. 408A(e)(2).

2. The requirement that only one tax-free rollover contribution can be made to a Roth IRA during any one-year period does not apply. I.R.C. 408A(e)(2)(B).

3. The rollover has to be made within one year of a receipt of payment. I.R.C. § 408A(e)(2)(A).

C. Exceptions.

1. Transfers directly from one trustee to another trustee are not rollovers and may be made at any time.

2. The transfer of an individual's interest in an IRA pursuant to a divorce decree or instrument incident to a divorce decree is not considered a taxable transfer or distribution. I.R.C. § 1041.

a. Must be received within one tax year.

b. Must roll into another IRA.

VI. TAX TREATMENT OF TRADITIONAL IRA DISTRIBUTIONS

A. Distributions are included in gross income and reported to the taxpayer on Form 1099-R. I.R.C. § 408(d). The taxpayer reports total IRA distributions on the applicable line of Form 1040.

B. Nondeductible contributions are not taxed when distributed.

1. Taxpayer has cost basis in the IRA on investment.

2. Earnings on nondeductible contributions are taxed when distributed.

3. Special accounting is required to compute tax on distributions if both deductible and nondeductible contributions were made.

4. Losses on IRA investments recognized only when entire IRA distributions are made.

C. Premature Distributions.

1. Taxpayer includes distributions received before age 59½ in gross income (Form 1040, line 15). In addition, the taxpayer must pay a 10% additional tax. Withdrawals before age 59½ are called premature or early withdrawals. This tax is 10% of the part of the distribution that the taxpayer must include in gross income. (Form 1040, line 58; Form 5329).

2. Exceptions to the 10% penalty:

a. The receipt of a distribution from a traditional IRA that includes a return of nondeductible contributions is not subject to the 10% penalty.

b. The 10% penalty does not apply if taxpayer dies or becomes disabled. I.R.C. § 72(t)(3)(A).

c. The 10% additional tax also does not apply to any "qualified reservist distribution" made to individuals ordered or called to active duty for more than 179 days (or an indefinite period) after 11 September 2001. I.R.C. § 72(t)(2)(G)(i).

d. Unemployed individuals: To the extent that they do not exceed qualifying medical insurance premiums, distributions by an IRA to certain unemployed individuals are not subject to the 10% penalty. I.R.C. § 72(t)(2)(D).

e. Qualified higher education expenses: The 10% penalty will not be charged if the individual uses the IRA money to pay for qualified higher education expenses for the individual, the spouse, child, or grandchild of the individual or their spouse. Qualified expenses are defined the same as for Section 529(e)(3). I.R.C. § 72(t)(2)(E).

f. First-time homebuyer expenses: The 10% penalty will not be charged if the individual uses the IRA money for certain expenses associated with buying a principal residence. Only $10,000 during the individual's lifetime may be withdrawn without a penalty for this purpose. I.R.C. § 72(t)(2)(F).

(1) Qualified expenses include acquisition costs, settlement charges and closing costs.

(2) The principal residence may be for the individual or the individual's spouse, child, grandchild, or ancestor.

(3) To be considered a first-time homebuyer, the individual must not have had an ownership interest in a principal residence during the two-year period ending on the date that the new home is acquired.

g. Annuity exception – taxpayer may receive distributions without penalty if distributions are part of a series of substantially equal payments over taxpayer's life, even if taxpayer is less than 59½. Two special requirements:

(1) At least 1 distribution annually, and

(2) Distribution payments continue for at least 5 years or until taxpayer reaches 59½, whichever is longer.

h. If a taxpayer made a contribution to an IRA during the tax year and withdraws the money before the due date of the tax return, then he will not be subject to the 10% penalty. If a taxpayer has an extension of time to file a tax return, then the taxpayer can withdraw the money from the IRA tax-free by the extended due date. However, the taxpayer must also withdraw any interest or other income earned on the contributions and include that in income.

D. Taxpayers receiving premature distributions must complete IRS Form 5329 and enter the amount of the tax on Form 1040.

E. Required Minimum Distributions (RMD) for Traditional IRAs.

1. Taxpayers must begin receiving distributions by April 1 of the year after they reach 72 (70½ for years before 2020). For all subsequent years, they must receive distributions before December 31.

2. The rules for a RMD:

a. During the IRA owner's lifetime, RMDs from the IRA account are paid over the owner's life expectancy as determined in the Uniform Life Table.

b. If the IRA owner is married to someone who is more than 10 years younger, the IRA owner may elect to take RMDs based on the Joint and Last Survivor Table IF the younger spouse is the only beneficiary to the IRA.

c. RMD is determined by dividing the balance of the IRA on 31 December of the year before the year of distribution by the number on the appropriate table.

3. Post-death rules for RMD.

a. First must determine if there is a designated beneficiary. Under the new rules, who the designated beneficiary is must be determined NLT 30 September of the year following the year of the owner's death.

b. The determination is based on who was named as a beneficiary before the owner's death and whether any such beneficiary has disclaimed an interest or "cashed out" his benefit by that date.

c. If benefits are payable to the owner's estate or to a charity, then there is no designated beneficiary for RMD purposes. (This results in the proceeds of the IRA having to be completely disbursed NLT the end of the 5th year following the death of the owner if the owner died before required beginning date OR over the owner's remaining life expectancy (as of the year of death) if he died after the required beginning date.

d. Rules if the IRA owner dies before the beginning date.

(1) No designated beneficiary: The IRA balance must be distributed in full NLT than the end of the fifth year following the year of death. This is automatically applied, and there is no exception.

(2) Designated beneficiary: The beneficiary takes an RMD based on his life expectancy using the Single Life Table (the IRA custodian may allow the beneficiary to elect the 5-year rule).

e. Rules if the IRA owner dies on or after the beginning date.

(1) No designated beneficiary: The RMD is figured based on the owner's life expectancy under the Uniform Life Table using the owner's age on his birthday during the year of death.

(2) Designated Beneficiary: The RMD is based on the beneficiary's life expectancy using the Single Life Table. (The beneficiary may elect to take the RMD over the owner's remaining life expectancy)

f. IRA with multiple beneficiaries. The account can be divided into separate accounts for each beneficiary to enable each beneficiary to take distributions over their own life expectancy. If it is not split, then the distributions are determined over the

life expectancy of the oldest beneficiary. The separate account must be established NLT the end of the year following the year of death of the owner.

4. Taxpayers have to pay a 50% excise tax on the excess amounts left in IRAs for any year that a RMD is not taken or not taken in full

VII. ROTH IRA

A. A Roth IRA is an IRA that is designated as such when it is established. I.R.C. § 408A(b). It is treated as a regular IRA except where special rules apply. I.R.C. § 408A(a).

B. Same contribution rules as traditional IRA, the lesser of compensation or the applicable annual amount. Contributions are nondeductible, but qualified distributions are not taxable and are not included in income. I.R.C. § 408A(c)(1), (d)(1)(A).

1. Individuals age 50 or older can contribute an additional $1,000 “catch up” contribution to a Roth IRA.

2. The income phase-out ranges are higher for a Roth IRA than a Traditional IRA.

C. Roth IRA contributions for a year must be made by April 15th (or applicable due date) of the following year. I.R.C. § 408A(c)(7).

D. Total contributions to traditional and Roth IRAs are aggregated for purposes of the annual limit. I.R.C. § 408A(c)(1).

E. The phaseout amounts for Roth IRA contributions are based upon modified adjusted gross income published each year by the IRS and based upon

statutory amounts of $150,000 (joint return) or $95,000, adjusted annually for inflation. I.R.C. § 408A(c)(3).

1. Modified AGI excludes income resulting from the rollover or conversion from a regular IRA to a Roth IRA. I.R.C. § 408A(c)(3).

2. AGI-based contribution limits for Roth IRAs apply regardless of whether the taxpayer participates in a qualified retirement plan.

F. Conversion of a Traditional IRA to a Roth IRA:

1. A taxpayer can convert a traditional IRA to a Roth IRA regardless of the taxpayer's AGI.

2. The conversion is subject to federal income taxation as if it was not rolled over, <u>but it is not subject to the 10% penalty</u> (I.R.C. § 408A(c)(3)(C)(i), (d)(3)(A)(ii).

3. If a taxpayer does so, the amount of money converted is included in his taxable income except to the extent that the regular IRA consisted of nondeductible contributions.

4. Basis recovery rules (requiring a prorated calculation) determine the taxable amount of the transaction.

5. Conversions <u>must</u> be reported on Form 8606.

6. Recharacterized Contributions**.**

   a. To provide relief for taxpayers who want to change the nature of an IRA contribution, I.R.C. § 408A(d)(6) allows taxpayers to treat the transfer of a contribution (or a portion of a contribution) from one type of IRA (the first IRA) to a different type of IRA (the second IRA), as if the original contribution had been made directly to the second IRA.

b. In effect, the contribution is reversed (recharacterized), and it and any associated earnings or losses are transferred back to the original IRA. Treas. Reg. § 1.408A-5, Q&A-1(a), clarifies that redesignating the first IRA as the second IRA is treated as a transfer of the entire account balance from the first IRA to the second IRA. Regardless of the method used, contributions not properly recharacterized may be subject to the excise tax under I.R.C. § 4973. Treas. Reg. § 1.408A-4, Q&A-3(b).

c. Only actual contributions can be recharacterized. Therefore, excess contributions made in a prior year and applied against the contribution limits in the current year under I.R.C. § 4973 cannot be recharacterized, unless the actual contribution still meets the recharacterization requirements.

d. Recharacterized contributions had to have been identified by 15 October of the year after the original conversion or contribution is made.

e. A taxpayer may not recharacterize a Roth *conversion*. A taxpayer may only recharacterize a *contribution* to a Roth IRA. I.R.C. § 408A(d)(6)(A), (C)(iii).

7. Reconversions.

a. A person who has converted an amount from a traditional IRA to a Roth IRA may not only transfer the amount back to a traditional IRA in a recharacterization, but may later reconvert that amount from a traditional IRA to a Roth IRA and, under certain circumstances, have the resulting income fixed at the time of the reconversion.

b. An IRA owner who converts an amount from a traditional IRA to a Roth IRA and then transfers that amount back to a traditional IRA by way of a recharacterization cannot reconvert that amount from the traditional IRA to another Roth IRA before the beginning of the tax year following the tax year in

which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by way of a recharacterization.

c. The timing rule applies regardless of whether the recharacterization occurs during the tax year in which the amount was converted to a Roth IRA or the following tax year. Treas. Reg. § 1.408A-5, Q&A-9, now provides rules for reconversions.

(1) Note: This restriction prevents a taxpayer from recharacterizing a Roth IRA as a traditional IRA if the market value of the IRA has been substantially reduced, e.g., because of a sharp decline in the market value of stocks held in the IRA, and then immediately reconverting to a Roth IRA to take advantage of the lower market value in determining the income to be reported from the conversion.

d. A reconversion made before the later of the beginning of the next tax year or the end of the 30-day period that begins on the day of the recharacterization is treated as a failed conversion, subject to correction through a recharacterization back to a traditional IRA.

(1) A failed conversion results in a distribution from the traditional IRA that is subject to tax (and possibly penalty tax) followed by a regular contribution to the Roth IRA.

(2) To the extent it exceeds the annual contribution limit, the amount treated as a regular contribution to the Roth IRA is treated as an excess contribution subject to the excise tax under I.R.C. § 4973. Treas. Reg § 1.408A-4, Q&A-3(b); Treas. Reg § 1.408A-4, Q&A-1(d); Treas. Reg § 1.408A-5, Q&A-9(a)(1).

(3) For purposes of the reconversion timing rules above, a failed conversion resulting from not having satisfied the statutory requirements is treated as a conversion in determining when an IRA owner may make a reconversion. Treas. Reg. § 1.408A-5, Q&A-9(a)(2).

8. What resources were used to pay the taxes?

a. A taxpayer electing to roll from a regular IRA to a Roth IRA must decide whether to take the resulting income tax from the distribution being received, while rolling the remainder to the Roth IRA. In the alternative, the taxpayer could pay the tax from another source.

b. If a taxpayer takes funds from the distribution to pay the tax, then that amount is ineligible for the special tax and penalty (10% penalty) treatment afforded rollovers to Roth IRAs.

9. If a taxpayer contributed money or made a contribution to a Roth IRA and later discovered their AGI for the year was too high or had second thoughts about the Roth contribution, then the taxpayer can move any contribution or rollover amount (plus attributable earnings) back from the Roth IRA to a regular IRA.

G. Distributions from Roth IRAs.

1. Qualified distributions from Roth IRAs are not included in income. I.R.C. § 408A(d)(1).

2. Qualified distributions are distributions made after the five-year period beginning with the first tax year the taxpayer or the taxpayer's spouse made a contribution to a Roth IRA, including a qualified rollover contribution from an IRA other than a Roth IRA (I.R.C. § 408A(d)(2)), and that are made:

a. On or after attaining age 59½,

b. At or after death (to a beneficiary or estate),

c. On account of disability, or

d. For a first-time home purchase expense under I.R.C. § 72(t)(2)(F). *See* I.R.C. § 408A(d)(2)(A); I.R.C. § 408A(d)(5); Treas. Reg. § 1.408A-6, Q&A-1.

3. Roth IRAs are not subject to the required minimum distribution rules of I.R.C. § 401(a)(9)(A) or the incidental death benefit requirements of I.R.C. § 401(a). *See* I.R.C. § 408A(c)(5).

VIII. COVERDELL EDUCATION SAVINGS ACCOUNT (CESA)

A. A CESA is a trust or custodial account established exclusively for the purpose of paying the beneficiary's qualified higher education expenses. I.R.C. § 530(b)(1); I.R.C. § 530(g).

B. Allowable annual contributions to CESAs are not deductible and are not taxable when withdrawn, but distributions of earnings from CESAs for qualified education expenses are tax-free.

1. Contributions:

a. Must be (I.R.C. § 530(b)(1)(A)):

(1) Cash;

(2) Made before the beneficiary reaches the age of 18 (or at any age for a child with special needs); and

(3) Are limited to $2,000 for the taxable year (except in the case of rollover contributions).

b. Contributions for the tax year must be made by the original due date of the return for that year (normally 15 April). I.R.C. § 530(b)(4).

c. The amount a taxpayer can contribute is phased out with modified adjusted gross income from $190,000 to $220,000 for taxpayers filing a joint return and $95,000 to $110,000 for all other taxpayers. I.R.C. § 530(c)(2). As a practical note, though, a low-tax-bracket grandparent or other person can contribute to a CESA for a beneficiary, even though the grandchild's parent is precluded from doing so (due to the parent's high income).

d. No deduction is allowed for Coverdell ESA contributions, but earnings the account are not subject to tax. I.R.C. § 530(e).

e. There is no limit on the number of CESAs that can be established designating the same child as the beneficiary. However, total contributions for the child during any tax year cannot be more than $2,000. I.R.C. § 530(b)(1)(A)(iii).

f. Contributions may be made during the same year to both a CESA and a Section 529 plan (see below) for the same student.

g. An individual who has received a military death gratuity or Servicemembers' Group Life Insurance (SGLI) payment can roll it over (contribute it) to one or more CESAs, without regard to the above annual contribution limit (I.R.C. § 530(d)(9)(A)) or the AGI phase-out limit.

(1) The contribution must be made before the end of the one-year period beginning on the date on which the contributor received the payment. I.R.C. § 530(d)(9)(A).

(2) The rule allowing only one rollover contribution to a CESA during any 12-month period does not apply to this rollover. I.R.C. § 530(d)(9)(B)).

2. Distributions are not included in gross income so long as they are used to pay for qualified education expenses. I.R.C. § 530(d)(2).

a. Qualified education expenses include (I.R.C. § 530(b)(2)(A)(i)-(ii)):

(1) Higher education tuition, fees, books, and supplies, certain room and board charges, as long as at least a half-time student, as defined in I.R.C. § 529(e)(3); and

(2) Elementary and secondary public and private or religious school tuition and expenses, including tutoring, room and board, transportation, uniforms, an extended day programs; computer technology or equipment or expenses for internet access and related services for use by the beneficiary and his family during any of the years that the beneficiary is in school, but not expenses for computer software designed for sports, games, or hobbies unless it is predominantly educational in nature. I.R.C. § 530(b)(3).

b. If distributions are for any other reason, then they are subject to taxation in a manner similar to regular IRAs. They are also subject to a 10% penalty. I.R.C. § 530(d)(4)(A). There is no penalty for distributions:

(1) made to a beneficiary or the estate of the beneficiary on or after the death of the designated beneficiary;

(2) attributable to the disability of the designated disability;

(3) made on account of a scholarship, allowance, or payment to the extent the distribution does not exceed the amount of the scholarship, allowance, or payment; or

(4) made on account of attendance at a military academy, to the extent that the distribution does not exceed the costs of advanced education. I.R.C. § 530(d)(4)(B).

3. Any account balance must be distributed within 30 days after the date the beneficiary reaches age 30 (unless the beneficiary has special needs), or if the beneficiary dies before reaching age 30, shall be distributed within 30 days after the day of death of the beneficiary. I.R.C. § 530(b)(1), (d)(8).

4. Any amount distributed from a CESA and rolled over to another education IRA for the benefit of the same designated beneficiary or certain members of the designated beneficiary's family (spouse or child or a descendant of a child; brother, sister, stepbrother, or stepsister; father or mother, or an ancestor of either; stepfather or stepmother; son or daughter of a brother or sister of the taxpayer; brother or sister of the father or mother of the taxpayer; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law) is not taxable, as long as the new beneficiary is under age 30 on the date of the rollover contribution to the new ESA. I.R.C. § 530(b)(6).

5. The American Opportunity Tax Credit and Lifetime Learning Credit may be taken in the same year that a tax-free ESA distribution for that student was taken. However, the expenses used to calculate the credit cannot include any expenses paid for by the ESA distribution. I.R.C. § 530(d)(2)(C).

C. There is no 6% excise tax on excess earnings if they are withdrawn before the beginning of the 6th month following the year of the contribution.

IX. QUALIFIED TUITION PROGRAMS (529 PLANS)

A. A qualified tuition program is one established and maintained by a State or agency or instrumentality, and there are two types (I.R.C. § 529(a)):

1. Prepaid tuition program, where the contributor purchases tuition credits or certificates on behalf of a designated beneficiary, which entitles the beneficiary to the waiver or payment of qualified higher education expenses (QHEE) of the beneficiary. I.R.C. § 529(b)(1)(A)(i).

2. Education investment plans, where the contributor deposits money into an account that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account. I.R.C. § 529(b)(1)(A)(ii).

B. In general, no amount shall be includible in the gross income of a designated beneficiary under a qualified tuition program or a contributor to such a program. I.R.C. § 529(c)(1). Additionally, there are no income restrictions on the individual contributors.

1. A contribution to a qualified tuition program shall be treated as a completed gift, but not as a qualified transfer for educational expenses (which are not treated as a transfer of property by gift). I.R.C. § 529(c)(2)(A). If the aggregate amount of contributions during a calendar year by a donor exceeds the annual gift tax exclusion, the donor may elect to take it into account as a gift ratably over a 5-year period. I.R.C. § 529(c)(2)(B).

2. Distributions are not included in income, as long as they do not exceed the QHEE of the distributee. I.R.C. § 529(c)(3)(B).

a. Qualified higher education expenses (QHEE) include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible education institution, as well as expenses for special needs services for a special needs beneficiary incurred in connection with such enrollment or attendance. I.R.C. § 529(e)(3)(A)(i)-(ii).

(1) QHEE also include expenses for the purchase of certain computer or peripheral equipment, computer software, or Internet access and related services, if such equipment, software, or services are to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution. For these types of QHEE, the computer software must not be designed for sports, games, or hobbies unless the software is predominantly educational in nature.

(2) QHEE include "expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school." I.R.C. § 529(c)(7). Cash distributions per beneficiary may not include for than $10,000 of such expenses per year. I.R.C. § 529(e)(3)(A).

b. QHEE for at least half-time students may also include the reasonable costs (as determined under the qualified tuition program) for room and board, but that amount shall not exceed the allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student or the actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

c. Expenses used to claim the American Opportunity Tax Credit or Lifetime Learning Credit may not be included as QHEE paid from Section 529 distributions. I.R.C. § 529(c)(3)(B)(v).

d. If the amount of distributions from Coverdell Education Savings Accounts (I.R.C. § 530) and Qualified Tuition Programs (I.R.C. § 529) exceed the amount of QHEE taken into account in the current year, then the expenses shall be allocated between the two programs to determine the taxable amount. I.R.C. § 529(3)(B)(vi).

e. Change in beneficiaries or programs (I.R.C. § 529(c)(3)(C)):

(1) Distributions are not taxable if they are transferred within 60 days of the distribution to another qualified tuition program for the benefit of the designated beneficiary or to the credit of another designated beneficiary who is a family member of the designated beneficiary with respect to whom the distribution was made.

(2) The designated beneficiary may be changed, as long as the new beneficiary is a member of the family of the old beneficiary.

f. An additional 10% penalty shall apply to distributions that are not used for qualified higher education expenses (the same as for Coverdell ESA distributions). I.R.C. § 529(c)(6).

g. A cash distribution that does not exceed the qualified higher education expenses (reduced by the in-kind expenses above) is not includible in the gross income of the distributee.

X. CONCLUSION

CHAPTER J

BUYING, OWNING, AND RENTING A HOME

TABLE OF CONTENTS

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

I. REFERENCES

A. Internal Revenue Code (I.R.C.), §§ 62(a)(4), 121, 162, 163-164, 167-168, 263, 280A, 461, 1011-1016.

B. Treasury Regulations ("Treas. Reg.").

C. IRS Publications.

1. Pub. 527, Residential Rental Property.

2. Pub. 530, Tax Information for First-Time Homeowners.

3. Pub. 535, Business Expenses.

4. Pub. 551, Basis of Assets.

5. Pub. 925, Passive Activity and At-Risk Rules.

6. Pub. 936, Home Mortgage Interest Deduction.

7. Pub 946, How to Depreciate Property

D. IRS Forms and Instructions: 1040, Schedules A & E; 982; 4562; and 8582.

II. TAX CONSEQUENCES OF BUYING A HOME

A. Home ownership – buying, owning, and selling – is perhaps the most significant investment the service member, as well as most Americans, make. Home ownership provides not only shelter from the elements, but can result in several tax consequences for the taxpayer arising from the purchase, the year-to-year ownership, and the sale of the home.

B. Determining the Original Basis of Residential Property. *See* I.R.C. § 1012; Pub. 551, Basis of Assets.

1. The original basis of a home is its cost (purchase price) including any debt assumed or incurred. I.R.C. § 1012.

2. If the home was constructed, its original basis is the cost of land plus the amount to construct the residential building.

3. A basis other than cost must be used if the property was acquired by inheritance or gift or received incident to divorce. I.R.C. §§ 1014, 1015, 1041); *see Godlewski v. CIR*, 90 T.C. 200 (1988).

4. Taxpayers must maintain accurate records showing the original basis of the property and all adjustments. The taxpayer bears the burden to prove basis.

C. Tax Treatment of Property Purchase Costs.

1. Costs Included in Basis:

a. Taxpayers can include in the basis of property the settlement fees and closing costs that are for buying it. A settlement fee or closing cost is considered to be for buying the property if you would have paid it even if you had paid cash.

b. Settlement fees or closing costs that you can include in the basis of your property include:

(1) Abstract fees,

(2) Charges for installing utility services,

(3) Legal fees (including title search and preparing the sales contract and deed),

(4) Recording fees,

(5) Surveys,

(6) Transfer taxes,

(7) Title insurance, and

(8) Any amount the seller owes that the buyer agrees to pay.

2. Certain costs of purchasing property may be deducted in the year of purchase.

a. Real estate taxes. I.R.C. § 164(d).

(1) From 2018 through 2025, the deduction for real estate taxes, combined with other state and local taxes, is limited to $10,000 per year. I.R.C. § 164(b)(6).

b. Real estate taxes are deductible to the extent they are imposed on the taxpayer.

c. The seller is treated as paying the property taxes up to, but not including, the date of sale.

d. The buyer is treated as paying the taxes beginning with the date of sale, despite the property tax accrual or lien dates under local law.

e. Mortgage Interest. I.R.C. § 163(h)(3).

(1) At settlement, purchaser is usually charged for daily interest from the day of settlement on the house until the end of the month. This may be claimed for the year in which house purchased.

(2) Mortgage lenders may neglect to report this – be sure to check settlement documents.

f. Points.

(1) Defined: charge by lenders above regular interest rate and must be stated as percentage of the mortgage loan. For example, one point on a $100,000 mortgage loan is $1,000.

(2) Possible tax treatments of points on home loans:

(a) Deductible as a mortgage interest expense, in full, in year paid;

(b) Deductible in installments over the life of the loan.

(3) Generally, prepaid interest paid as points must be spread over the life of a mortgage. I.R.C. § 461(g)(1).

(a) *See* Rev. Proc. 87-15, 1987-1 C.B. 624 for the method for determining the amount of points allocable to, and deductible in, each taxable year.

(b) To determine how much to deduct each year, divide the cost of the points by the total number of loan payments and multiply the quotient by the number of payments made in the tax year.

(4) You can fully deduct the points in the year of purchase if (1) your loan is secured by your main home; (2) points are generally imposed in the local real estate market and the amount you paid is no more than what is generally paid in the local real estate market; (3) you pay them to purchase, construct or improve your home; (4) they were computed as a percentage of the principal amount of the mortgage; (5) the amount paid is clearly shown on the HUD-1 as points; and (6) they are paid with funds other than those obtained from the lender (pre-1994 alternative–a moving expense deduction). I.R.C. § 461(g)(2).

(5) Points paid to refinance a mortgage, regardless of how they are paid, are not deductible in full in the year paid unless they are paid in connection with the improvement of a home. Rev. Proc. 94-27.

(6) If the points paid represent interest, but the points were higher than those generally charged in the local real estate market, then the amount of points in excess of the norm must be prorated over the life of the loan.

(7) If the points represent compensation for services that ordinarily are stated separately on the settlement statement (i.e., appraisal fees, inspection fees, title fees, attorney fees and property taxes), they are not interest and cannot be deducted either in the year of purchase or over the life of the loan. Such points may be added to the home's basis.

(8) Only the buyer may deduct seller-paid points as interest. Buyer lowers basis by the amount of the seller-paid points.

g. VA/FHA Loan Origination Fees. Deductible if the Uniform Settlement Statement (Form HUD-1) clearly designates the amounts as points. This revenue procedure expressly includes VA and FHA loan origination fees as examples of items clearly designated as points. Rev. Proc. 94-27.

3. Some costs incurred in purchasing a home are neither deductible nor added to basis.

a. Fire insurance premiums,

b. Charges for utilities,

c. Rent for occupying the home before closing,

d. Homeowners association fees,

e. Other fees or charges for services concerning occupying the home, and

f. Charges connected with getting or refinancing a mortgage loan, such as:

(1) FHA mortgage insurance premiums and VA funding fees,

(2) Loan assumption fees,

(3) Cost of a credit report, and

(4) Fee paid for an appraisal required by the lender.

D. First-Time Homebuyer Tax Credit (I.R.C. § 36) (Note: This applies to purchases that were made during or prior to 2010 (military were allowed an extra year until 2011). This section has been intentionally left in the outline as a reference in case the tax credit recapture provisions apply in your case.)

1. Amount.

a. A credit of the lesser of 10% of the purchase price of the residence, or

b. $8,000 ($4,000 if married filing separately) for a first-time homebuyer. If two or more individuals (not married to each other) purchase the residence, the total credit for all individuals is limited to $8,000.

c. $6,500 ($3,250 if married filing separately) for a long-time resident.

d. $7,500 for purchases between April 8, 2008 and December 31, 2008.

2. Eligibility.

a. First-time homebuyer. A first time homebuyer is any individual if the individual (and spouse, if married) had no ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence. An individual may still have an ownership interest in a rental property and qualify as a first-time homebuyer.

b. Long-time resident. For purchases after November 7, 2009. A long-time resident must have owned and used the same home as the principal residence for at least five consecutive years of the eight-year period ending on the date the resident purchases the new principal residence. For an eligible taxpayer who, for example, bought a home on Nov. 30, 2009, the eight-year period would run from Dec. 1, 2001, through Nov. 30, 2009.

c. Purchase the principal residence before May 1, 2010 or enter into a contract to purchase the principal residence before July 1, 2010 with a settlement date prior to September 1, 2010.

d. Modified AGI for purchase prior to November 6, 2009 must be less than $75,000 ($150,000 if married, filing jointly). Credit amount is fully phased out at $95,000 ($170,000).

e. Modified AGI for purchases after November 6, 2009 must be less than $125,000 ($225,000 if married, filing jointly). Credit amount is fully phased out at $145,000 ($245,000).

f. Must acquire the home and use it as the principal residence for at least three years. Note: this provision, which requires recapturing the credit if the home ceases to be the principal residence during the three year period, is waived for military members who cease using the home as a principal residence because of being transferred pursuant to military orders outside of the area.

g. May not dispose of the principal residence during the year of purchase.

3. Recapture of the $7,500 credit for purchases between April 8, 2008 and December 31, 2008.

a. Credit repaid in equal installments over 15-year period.

b. Recapture period begins in the second taxable year after purchase. (i.e., if purchase occurs in 2010, first recapture payment occurs in 2012).

c. If principal residence is sold before credit is fully repaid, entire unrecaptured amount becomes due in the year of sale.

d. For purchases between January 1, 2009 and November 30, 2009, there is no recapture, *provided* the home is used as the principal residence for the first 36 months following the purchase. The entire credit is recaptured if the home ceases to be used as the principal residence before the end of the 36-month period.

4. Military exceptions.

a. Members of the military serving <u>outside</u> the U.S. have an extra year to buy a principal residence in the U.S. and qualify for the credit.

(1) A member must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2011 and must close on the purchase on or before June 30, 2011.

(2) This applies to members who serve on qualified official extended duty service outside of the United States for at least 90 days during the period beginning after 31 December 2008 and ending before 1 May 2010.

b. The recapture provision is waived for a member who ceases to use the home as the principal residence during the three-year period because of being transferred pursuant to military orders outside of the area.

5. Filing requirements.

a. Must file a paper return.

b. File a Form 5405, *First Time Homebuyer Credit and Repayment of the Credit.*

c. Properly executed settlement statement/Form HUD-1.

III. TAX CONSEQUENCES OF OWNING A HOME

A. Deductions.

1. Home mortgage interest deduction rule. I.R.C. § 163(h)(2)(D), (h)(3)(A). Qualified residence interest is deductible as an itemized deduction.

2. Qualified residence interest. I.R.C. § 163(h)(3). Qualified residence interest means interest paid on "acquisition indebtedness" or "home equity indebtedness" on a "qualified residence."

a. "Acquisition indebtedness" is a debt used to acquire, construct, or substantially improve a home provided the debt is secured by a qualified residence.

(1) Acquisition indebtedness incurred after 15 December 2017 is limited to $750,000 for years 2018 through 2025. An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (commonly known as the "Tax Cuts and Jobs Act"), Pub. L. No. 115-97, 131 Stat. 2054, § 11043 (Dec. 22, 2017) (adding I.R.C. § 163(h)(3)(F)).

(a) Loans on or before 15 December 2017 are grandfathered (i.e., the $1,000,000 limit still applies). Also excepted from the $750,000 limit were binding contracts entered into before 15 December 2017 and that closed before 1 January 2018, if closing occurred before 1 April 2018. I.R.C. § 163(h)(3)(F)(i)(III)-(IV).

(2) Refinancing is also grandfathered as long as the new principal amount does not exceed the old amount. I.R.C. § 163(h)(3)(F)(iii).

(3) For loans on or before 15 December 2017, acquisition indebtedness may not exceed $1,000,000 ($500,000 for a married person filing a separate return). I.R.C. §163(h)(3)(B).

b. "Home equity indebtedness" is any indebtedness secured by a qualified residence to the extent of the lesser of the fair market value of the house, or $100,000 ($50,000 for married individual filing separately) (I.R.C. §163(h)(3)(C)). Allows homeowners to deduct interest on home equity loans even if the loan proceeds are used for personal purposes.

(1) Before 2018, home equity interest was deductible up to these limits even if the loan was used for personal purposes. After the TCJA, home equity interest is deductible only if used to buy, build, or improve the taxpayer's main residence. I.R.C. § 164(h)(3)(F)(i)(I).

c. "Qualified residence" includes the taxpayer's principal residence (same definition as I.R.C. § 121) and one other home. I.R.C. §§ 280A(d)(1), 163(h)(4).

d. "Residence" is determined based on facts and circumstances. A "residence" generally includes houses, condominiums, cooperatives, mobile homes, houseboats, or trailers that contain sleeping space, toilet and cooking facilities. Treas. Reg. § 1.163-10T(f)(1)(ii) & (p)(3)(ii).

e. Debt must be secured by a qualified residence. I.R.C. § 163(h)(3)(B)(i)(II)). See also I.R.S. Priv. Ltr. Rul. 9418001

(interest on taxpayer's home purchase loan was secured by interest in rental property not home purchased and was not deductible).

f. Special grandfather rule exists for pre-October 13, 1987, indebtedness. If debt secured by qualified residence was incurred prior to this date, it is not subject to $1,000,000 acquisition debt limit. I.R.C. § 163(h)(3)(D).

g. Taxpayers who have used mortgage loans for a purpose other than to purchase, construct, or substantially improve the home should consult Pub. 936.

3. Real estate taxes. See Chapter D. Note the following:

a. Real estate taxes placed in escrow may exceed those actually paid by the lender to the taxing authority. Only those actually paid by the lender to the taxing authority may be deducted.

b. A taxpayer generally may not deduct assessments for local benefits, such as for construction of streets, sidewalks, or water and sewage system, which tend to increase the value of the property. I.R.C. § 164(c)(1). These costs must be added to the cost basis.

4. Casualty and theft losses. I.R.C. § 165(c). See Chapter D.

B. Adjustments to Basis. I.R.C. § 1016.

1. The basis of property is adjusted for any expenditure, receipt, loss or other item properly chargeable to capital account, including improvements and betterments made to the property. I.R.C. § 263; Treas. Reg. § 1.1016-2(a); Pub. 551.

a. An improvement materially adds value, prolongs life, or adapts home to a new use.

b. The amount added to the basis is the actual cost of the improvement plus debt incurred.

2. Local property assessments.

3. Casualty losses.

4. Depreciation allowed - if home had been rented previously.

5. Gain previously deferred. *See* material pertaining to I.R.C. § 1034.

C. Nondeductible Expenses.

1. Utility fees and assessments for services such as water, sewage, and trash or garbage collection.

2. Expenses for maintenance and repairs.

3. Insurance premiums.

a. Mortgage insurance premiums are deductible for certain years. This deduction is established on a short-term basis that expires by its terms (an example of a so-called "tax extender" provision). To determine if mortgage insurance is deductible in any year, consult Pub. 936.

4. Loan assumption fees, credit reports, and appraisals.

IV. RENTAL INCOME

A. Military taxpayers who rent houses report and net rental income and rental deductions/depreciation on Form 1040, Schedule E. Rental expenses may offset rental income and other income (e.g., salary, interest, and dividends) when the taxpayer performs some management role. In that case, the taxpayer-landlord may be able to deduct up to $25,000 of real estate rental losses from other income (taxpayer's AGI must be less than $100,000).

B. Rental Income Is Included in Gross Income. I.R.C. § 61(a)(5).

1. Rent is a payment received (or constructively received) for the use and occupancy of property.

2. Rental income includes advance payments of rent (amount received before the period it covers).

3. If a security deposit is to be used as the last month's rent, it is included as rental income in the year paid. If the landlord intends to return it to the tenant at the end of the lease, it is not included as income. Generally, security deposits are not considered rent.

4. Insurance proceeds for loss of rental income because of fire or other casualty are income.

5. Payments by the tenant for canceling or modifying the lease are considered rental income when received.

6. Rental income also includes expenses paid by a tenant. Treas. Reg. § 1.61-8(c). Improvements made by a tenant are not income.

7. If property or services are received as rent instead of cash, include the fair market value of the property or services as rental income.

C. Reporting Rental Income (Schedule E).

1. Rental income is reported by cash basis taxpayers when received and by accrual basis taxpayers when due unless the rent is considered uncollectible.

2. All rental income must be reported on Schedule E.

3. If more than three rental properties, attach additional Schedule Es.

4. Use Schedule E, Parts II - IV, to report income from estates, partnerships, S corporations, trusts, and real estate mortgage investment conduits.

V. RENTAL EXPENSES

A. General Rule: Deduct rental expenses in the year paid or incurred.

B. Types of Rental Expenses. I.R.C. § 62(a)(4); Treas. Reg. § 1.62(c)(8).

1. Advertising.

2. Automobile and travel expenses to check on the property.

a. "Ordinary and necessary costs" incurred to collect rental income or to manage, conserve, or maintain the rental property.

b. Includes actual costs of car, air, train, and bus fares.

c. Instead of computing actual expenses, a taxpayer may deduct a standard mileage rate.

3. Cleaning and maintenance expenses.

4. Commissions paid to find tenants.

5. Insurance.

6. Legal and professional fees.

7. Management fees.

8. Mortgage interest.

9. Other interest.

10. Repairs.

a. Repairs are expenses to keep the property in good working order and are not capital improvements (e.g., repainting, fixing gutters or floors, plastering, replacing broken windows).

b. Improvements are not deductible but must be added to the capital account and depreciated.

(1) Improvements add to the value of the property, prolong its useful life, or adapt it to new uses.

(2) Add the cost of improvements made before the property is rented to the basis of the property.

c. Repairs may constitute improvements when they are undertaken as part of an extensive renovation plan.

11. Supplies.

12. Taxes.

13. Utilities and fees for services provided tenants.

14. Other ordinary and necessary expenses. I.R.C. §§ 162, 212.

C. Dividing Expense Deductions Between Personal and Rental Use.

1. If part of a dwelling is rented, the expenses must be prorated between the personal expenses and the rental expenses. Expenses which only relate to the rental activity need not be prorated.

a. Any reasonable method of prorating expenses may be used.

b. Some of the personal expenses (interest and taxes) may still be deductible as an itemized deduction on Schedule A.

2. If the property is converted during the tax year to rental (or back to personal) use, allocate the expenses based on the number of months used for rental purposes.

D. Vacation Properties. I.R.C. § 280A.

1. If a taxpayer uses a dwelling unit as a residence, limits apply to the deductions that can be claimed.

2. To constitute use as a residence, the property must be subject to personal use for a period of more than 14 days or 10 percent of the period the property is actually rented out, whichever is greater.

3. Personal use includes use by anyone who has an interest in the property or their family members, unless fair market rental is paid.

a. Any use for less than fair rental value is personal use.

b. Use by one who permits the owner to use another property is personal use.

c. Shared equity arrangements are an exception to the personal use rules.

4. Exceptions to the limitations.

a. If the property is rented for fewer than 15 days, and is used as a residence, none of the rental expenses are deductible on Schedule E. All interest, taxes, and casualty losses will be deductible, if at all, as itemized deductions on Schedule A. However, neither is the rent included in gross income. I.R.C. § 280A(g).

b. If the property is used as a principal residence, either before or after the rental period, the days occupied as a primary residence may not be counted as personal use.

5. If the taxpayer has used the dwelling unit and rented it, the expenses must be divided between rental use (Schedule E) and personal use (Schedule A).

6. Limitations on deductions. If property has been used as a residence during the rental period, the taxpayer can only deduct rental expenses in the following order:

a. Interest, taxes, and casualty losses that are allocable to the rental use (these expenses are always deductible in full).

b. Operating and maintenance expenses, other than depreciation, are next deducted, but only to the extent that rental income exceeds the deductions in item a., above.

c. Depreciation deductions are allowed only to the extent that rental income exceeds the deductions in items a. and b., above.

E. Note. Rental real estate activities can qualify for the qualified business income (QBI) deduction in certain circumstances. Rev. Proc. 2019-38, 2019-09 I.R.B. 740. In Rev. Proc. 2019-38, the IRS established a safe harbor to claim the deduction. The safe harbor requires, among other things, that the taxpayer maintain separate book and records for the property and document at least 250 hours of rental services (not financial or investment management activities) performed per year by owners, employees, agents, or contractors. Rev. Proc. 2019-38, §§ 3.03, 3.04.

VI. DEPRECIATION

A. See Pubs. 527, Residential Rental Property, and 946, How to Depreciate Property.

B. Determining Depreciation. How much depreciation can be deducted is determined mainly by:

1. Basis in the property; and

2. Recovery period for the property.

C. What Can Be Depreciated?

1. Real property other than land.

2. Personal property.

3. Property that meets all three of the following conditions:

a. Used in business or held for the production of income;

b. Has a determinable useful life longer than one year; and

c. Is something that wears out, gets used up, decays, becomes obsolete, or loses value from natural causes.

D. Basis for Depreciation.

1. The basis of property held for rent is generally its cost, minus the value of land.

2. If property originally used for personal use is converted, basis is the lower of adjusted basis or fair market value on the date of conversion.

3. Depreciation will be disallowed if basis cannot be proved.

4. Total depreciation claimed must not exceed the depreciable basis of the property.

5. Deducting depreciation is not an election: allowable depreciation not deducted is lost and will reduce the basis at time of sale. I.R.C. § 1016(a)(2).

E. Methods of Depreciation.

1. Property placed in service before 1981 could be depreciated under several methods.

   a. Straight line.

   b. Declining balance method.

2. Property "placed in service" after 1980, but before 1987, was depreciated using the Accelerated Cost Recovery System (ACRS).

   a. If taxpayer used the property (or a relative owned it) before 1981, and converted it to rental property after 1980, the ACRS system cannot be used.

   b. ACRS allows rapid recovery of an asset cost using fixed recovery schedules over prescribed periods.

      (1) No need to estimate useful life.

      (2) Salvage value need not be estimated.

   c. Recovery periods for property placed in service before 1987:

      (1) 3-Year Property: Includes personal property with a midpoint class life of 4 years or less (automobiles, light trucks).

      (2) 5-Year Property: Personal property that is not 3-, 10-, or 15-year property (includes most office equipment like computers, as well as office furniture).

      (3) 15-year property: Real property placed in service between December 31, 1980 and March 16, 1984.

(4) 18-Year Property: Real property placed in service after March 15, 1984 and before May 9, 1985.

(5) 19-Year Property: Real property placed in service after May 8, 1985, but before 1 January 1987. Those who place real property in service after 31 July 1986 may elect a modified ACRS under the Tax Reform Act of 1986.

3. Modified Accelerated Cost Recovery System (MACRS). I.R.C. § 168.

a. The Tax Reform Act of 1986 modified the ACRS system for all property "placed in service" after 31 December 1986.

(1) Property used as a home prior to 1986 and converted after 1986 must be depreciated under MACRS.

(2) Taxpayers may elect to have a modified ACRS system apply to property placed in service after 31 July 1986 but before 31 December 1986.

b. MACRS provides two systems for depreciating property.

(1) General Depreciation System. GDS property is assigned a certain recovery period (i.e., 3, 5, or 7 years) and uses two methods of depreciation--declining balance (accelerated depreciation) and straight line (constant depreciation).

(2) Alternative Depreciation System. ADS property is assigned a certain recovery period (usually longer than the GDS method) and is depreciated using the straight-line method. A taxpayer may elect to use this method.

c. To figure the MACRS deduction, the taxpayer must know the following about the property:

(1) Its recovery period (and the applicable convention);

(2) Its placed-in-service date; and

(3) Its depreciable basis.

d. Recovery Periods Under MACRS.

(1) The 3-, 5-, 10-, and 15-year recovery classes under ACRS are retained. Cars are shifted from 3- to 5-year class.

(2) Nonresidential real property. This class includes any real property with a class life of 27.5 years or more that is not residential rental property. This property is depreciated over 39 years.

(3) Residential real property. This class includes any real property that is a rental building or structure for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If any part of the building or structure is occupied by the taxpayer, the gross rental income includes the fair rental value of the part the taxpayer occupies.

(a) This property is depreciated over 27.5 years under the GDS method.

(b) This property is depreciated over 40 years using the ADS method.

e. Residential and nonresidential property must be depreciated using the straight-line method.

f. All residential real property placed in service is treated as placed in service on the midpoint of that month (mid-month convention). All other property is treated as being placed in service in the middle of the year.

g. Depreciation can begin when the property is placed in service. "Placed in service" for a rental property means when the property is ready and available for a specific use in that activity.

4. The depreciation deduction for each year of the recovery period is figured by applying a certain depreciation method (e.g. straight line or declining balance) to the property's adjusted basis. The taxpayer can calculate this manually or use tables provided by the IRS (see Pub. 946).

a. The adjusted basis does not include the value of land.

b. The percentage of depreciation used each year varies with the property's recovery period and the method of depreciation used (e.g., straight line or declining balance). In the first year, the percentage also varies with the applicable convention (e.g., mid-month or half-year).

c. The percentages in the tables are applied to the adjusted basis of the property each year of the recovery period.

(1) For the purpose of computing the annual deduction, the taxpayer does not reduce the adjusted basis by the amount of depreciation taken in prior years.

(2) For the purpose of computing gain or loss on the sale of the property, the taxpayer must reduce the adjusted basis by the amount of depreciation taken in prior years.

5. Depreciation deduction for improvements.

a. The period for computing depreciation begins on the date in which the addition or improvement is placed in service.

b. Example. Colonel Jones owns rental property in Washington, D.C. and has been depreciating the property since 1984 under ACRS. In 2006, he adds an addition. He must depreciate the addition under the MACRS system (residential real property class).

6. If the property is disposed of before being completely depreciated, depreciation for the final year can only be taken for the number of months in service during the year of sale.

7. Figure depreciation on Form 4562, and transfer the result to the appropriate form, normally Schedule E (or Schedule C if a business). Refer to Pub. 946 for additional guidance. A taxpayer need not complete Form 4562 if the only depreciation claimed is for property placed in service prior to the current tax year; enter this depreciation directly on Schedule E.

VII. PASSIVE LOSS LIMITATIONS

A. General Rules. I.R.C. § 469.

1. Individuals cannot offset income, other than income from passive activities, with losses from passive activities.

2. A passive activity is any activity involving the conduct of any trade or business in which the taxpayer does not materially participate.

   a. Material participation requires regular, continuous, and substantial involvement.

   b. Passive activities include most limited partnerships and all rental activities regardless of material participation.

3. Net passive activity losses and passive activity credits are disallowed but may be carried forward to next tax year. All passive activity losses (not credits) that have accumulated will be allowed in year property is disposed. I.R.C. § 469(g).

B. Losses From Rental Real Estate.

1. A special rule allows a $25,000 offset of nonpassive income ($12,500 for married couples who lived apart for the entire year filing separately) for rental real estate activity losses.

2. To constitute non-passive income, the taxpayer must "actively participate" in the rental activity.

    a. Not the same standard as material participation.

    b. Satisfied if taxpayer participates in significant and bona fide sense, e.g., approves lease terms, tenants, and repair decisions.

3. Ownership limitation: taxpayer must own at least a 10% interest.

4. Taxpayer must have a modified Adjusted Gross Income (AGI) less than $150,000. The special $25,000 offset is phased out by 50% of the amount that modified AGI exceeds $100,000. No loss is allowed when the modified AGI exceeds $150,000.

5. Passive activity losses and credits are computed on Form 8582, Passive Activity Loss Limitations. Taxpayers do not have to complete and file Form 8582 if:

    a. Losses are only from rental activities.

    b. There are no credits with the rental activities.

    c. Taxpayer actively participated in the rental activity.

    d. There are no losses or credits from any other passive activity.

    e. Total losses from rental real estate activity are less than $25,000.

    f. Modified adjusted gross income is less than $100,000.

    g. Taxpayer lived apart from spouse for entire tax year if married filing separate returns are filed.

6. Enter the amount of deductible real estate loss on Schedule E.

C. At-Risk Rules. The at-risk rules apply to real estate placed in service after 1986. Under these rules, any loss from an activity is allowed only to the extent of the total amount a taxpayer has at risk in the property (e.g., to the extent of the adjusted basis).

VIII. CONCLUSION

CHAPTER L

SELLING A HOME OR RENTAL PROPERTY

TABLE OF CONTENTS

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

I. REFERENCES

A. Internal Revenue Code (I.R.C.), §§ 61(a)(5), 121, 1001, 1014-1016, 1031, 1231, 1245, 1250.

B. Treasury Regulations (Treas. Reg.), §§ 1.61-6, 1.61-8, 1.121-1 – 1.121-5, 1.165-9.

C. IRS Publications.

1. Pub. 523, Selling Your Home.

2. Pub. 527, Residential Rental Property.

3. Pub. 530, Tax Information for First-Time Homeowners.

4. Pub. 544, Sales and Other Dispositions of Assets.

5. Pub. 551, Basis of Assets.

6. Pub 946, How to Depreciate Property.

D. IRS Forms and Instructions: 1040 (Schedule D), 4562, 4797, 8582, 8949.

II. INTRODUCTION

Determining the gain and tax due arising from the sale of rental property is complex. The complexity arises from the "business use" of such property, the ability to depreciate this property, the requirement to adjust the basis of the property for such allowable depreciation, and the requirement to recapture gain attributable to depreciation.

III. GAIN, LOSS, AND OTHER USEFUL DEFINITIONS

A. Gain: The amount realized from the sale or exchange of property that is more than the adjusted basis.

B. Loss: The adjusted basis of the property that is more than the amount realized.

C. Basis: The amount from which gain or loss is determined. The original basis of a home is its cost (purchase price) including any debt assumed or incurred. I.R.C. § 1012. If the home was constructed, its original basis is the cost of land plus the amount to construct the residential building. A basis other than cost must be used if the property was acquired by inheritance, gift or received from spouse incident to divorce.

D. Adjusted Basis: The adjusted basis of property is the original cost or other basis plus certain additions and minus certain deductions, such as depreciation and casualty losses. I.R.C. § 1016.

E. Amount realized: The amount realized from a sale or exchange is the total of all money received plus the fair market value of all property or services received. I.R.C. § 1001. The amount realized also includes any liabilities that were assumed by the buyer and any liabilities to which the property transferred is subject, such as real estate taxes or a mortgage.

F. Amount recognized: That portion of an amount realized, which bears some economic or tax consequence. Gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes.

Recognized gains must be included in gross income. Recognized losses may be deductible from gross income.

G. Fair market value: The price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of the relevant facts.

IV. HOW TO FIGURE GAIN OR LOSS

A. To figure the gain or loss on the sale of a main home, the taxpayer must know the selling price, the amount realized, and the adjusted basis.

1. Selling price.

a. The selling price is the total amount the taxpayer receives for his home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

b. The selling price of the home does not include amounts received for personal property sold with the home. Personal property is property that is not a permanent part of the home. Examples are furniture, draperies, and lawn equipment. Separately stated cash received for these items should not be shown on Form 1099-S.

c. Payment by employer. The home may be sold because of a job transfer. If the employer pays for a loss on the sale or for selling expenses, do not include the payment as part of the selling price. The employer will include it in box 1 of the Form W–2 and the taxpayer will include it on his or her Form 1040.

2. Amount realized.

a. The amount realized is the selling price minus selling expenses.

b. Selling expenses include commissions, advertising fees, legal fees, and loan charges paid by the seller, such as loan placement fees or "points."

c. Adjusted basis. While the taxpayer owns the home, he may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

B. Amount of gain or loss.

1. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part that may be excluded, generally is taxable.

2. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of a main home cannot be deducted. I.R.C. § 165; Treas. Reg. § 1.165-9.

3. Jointly owned home.

a. If the taxpayer and his spouse sell a jointly owned home and file a joint return, they figure the gain or loss as one taxpayer.

b. If the taxpayers file separate returns, each must figure their own gain or loss according to the individual ownership interest in the home. State law determines ownership interest.

c. If the taxpayer and a joint owner other than the spouse sell a jointly owned home, then each of must figure their own gain or loss according to the individual ownership interest in the home.

C. Basis.

1. Cost as Basis. I.R.C. § 1012. The cost of property is the amount paid for it in cash, debt obligations, or other property.

a. Cost basis includes the purchase price and certain settlement or closing costs. The purchase price includes the down payment and any debt, such as a first or second mortgage or notes given the seller in payment for the home.

b. Settlement fees or closing costs.

(1) Include in basis the settlement fees and closing costs paid for buying the home. Do not include in basis the fees and costs for getting a mortgage loan. A fee for buying the home is any fee you would have had to pay even if you paid cash for the home.

(2) Settlement fees do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

(3) Settlement fees or closing costs that can be included in the basis of the property are:

(a) Abstract fees (abstract of title fees),

(b) Charges for installing utility services,

(c) Legal fees (including fees for the title search and preparing the sales contract and deed),

(d) Recording fees,

(e) Survey fees,

(f) Transfer taxes,

(g) Owner's title insurance, and

(h) Any amounts the seller owes that the buyer agrees to pay, such as:

(i) Certain real estate taxes,

(ii) Back interest,

(iii) Recording or mortgage fees,

(iv) Charges for improvements or repairs, and

(v) Sales commissions.

(4) Settlement fees and closing costs not included in basis are:

(a) Fire insurance premiums,

(b) Rent for occupancy of the house before closing,

(c) Charges for utilities or other services related to occupancy of the house before closing,

(d) Any fee or cost that you deducted as a moving expense (allowed for certain fees and costs before 1994),

(e) Charges connected with getting a mortgage loan, such as:

(i) Mortgage insurance premiums (including VA funding fees),

(ii) Loan assumption fees,

(iii) Cost of a credit report, and

(iv) Fee for an appraisal required by a lender, and

(f) Fees for refinancing a mortgage.

c. Construction. If the taxpayer contracted to have the house built on land owned by the taxpayer, the basis is:

(1) The cost of the land, plus

(2) The amount it cost to complete the house, including:

(a) The cost of labor and materials,

(b) Any amounts paid to a contractor,

(c) Any architect's fees,

(d) Building permit charges,

(e) Utility meter and connection charges, and

(f) Legal fees directly connected with building the house.

(3) Cost includes down payment and any debt, such as a first or second mortgage or notes given the seller or builder. It also includes certain settlement or closing costs.

(4) Self-built. If the taxpayer built all or part of the house himself, its basis is the total amount it cost to complete the home. Do not include in the cost of the house:

(a) The value of the taxpayers own labor, or

(b) The value of any other labor the taxpayer did not pay for.

2. Basis Other Than Cost.

a. Home received as gift. I.R.C. § 1015.

(1) The donee acquires the adjusted basis of the donor.

(2) Exception:

(a) If using the donor's adjusted basis results in a loss upon sale of the home, the donee must use the home's fair market value at time of transfer as the basis for the sale.

(b) If using the fair market value results in a gain (while using the donor's adjusted basis would have resulted in a loss), then the donee recognizes neither a gain nor a loss upon the sale.

b. Home received from spouse/incident to divorce. I.R.C. § 1041.

(1) If received after July 18, 1984,

(a) No gain or loss on the transfer is recognized.

(b) Basis in this home is generally the same as spouse's (or former spouse's) adjusted basis just before the property is received. This rule applies even if received in exchange for cash, the release of marital rights, the assumption of liabilities, or other consideration.

(2) Transfers before July 19, 1984, in exchange for release of marital rights, basis in the home is generally its fair market value at the time it is received.

c. Home received as inheritance. I.R.C. § 1014.

(1) Generally,

(a) The basis is its fair market value on the date of the decedent's death, or

(b) The later alternate valuation date if that date was used for federal estate tax purposes.

(c) If an estate tax return was filed, the value listed there for the property generally is your basis.

(d) If a federal estate tax return did not have to be filed, the donee's basis in the home is the same as its appraised value at the date of death for purposes of state inheritance or transmission taxes.

(2) Surviving spouse. I.R.C. §§ 1015, 2040.

(a) A surviving spouse, who owned the home jointly with the decedent spouse, acquires a basis equal to:

(i) Basis for the half interest that the decent spouse owned will be one-half of the fair market value on the date of death (or alternate valuation date),

(ii) The basis in the surviving spouse's half will remain one-half of the adjusted basis determined previously.

(b) Example. The jointly owned home had an adjusted basis of $50,000 on the date of the first spouse's death, and the fair market value on that date was $100,000. The surviving spouse's new basis in the home is $75,000 ($25,000 for one-half of the adjusted basis plus $50,000 for one-half of the fair market value).

d. Community property. I.R.C. § 1015.

(1) In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), each spouse is usually considered to own half of the community property.

(2) When either spouse dies, the fair market value of the community property generally becomes the basis of the entire property, including the part belonging to the surviving spouse.

(3) For this to apply, at least half the value of the community property interest must be includible in the decedent's gross estate, whether or not the estate must file a return.

D. Adjusted Basis. I.R.C. § 1016.

1. Adjusted basis is the original basis increased or decreased by certain amounts.

a. Increases to basis, include any:

(1) Improvements that have a useful life of more than 1 year,

(2) Additions,

(3) Special assessments for local improvements, and

(4) Amounts spent after a casualty to restore damaged property.

b. Decreases to basis, include any:

(1) Gain postponed from the sale of a previous home before May 7, 1997,

(2) Deductible casualty losses,

(3) Insurance payments you received or expect to receive for casualty losses,

(4) Payments you received for granting an easement or right-of-way,

(5) Depreciation allowed or allowable if the home is used for business or rental purposes,

(6) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy

improvements that you added to the basis of the home,

(7) Adoption credit claimed for improvements added to the basis of the home,

(8) Nontaxable payments from an adoption assistance program of the employer used for improvements added to the basis of the home,

(9) First-time homebuyers credit (allowed to certain first-time buyers of a home in the District of Columbia), and

(10) Energy conservation subsidy excluded from the taxpayer's gross income because he received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

V. EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE

A. Recall than gain derived from the sale of property is taxable unless specifically excluded by the Internal Revenue Code. I.R.C. § 61(a)(3) (gross income includes "[g]ains derived from dealings in property").

B. Losses sustained on the sale of a personal residence are <u>not</u> deductible. I.R.C. § 165, Treas. Reg. § 1.165-9.

C. General rule for exclusion of gain on the sale of a principal residence. I.R.C. § 121. The Internal Revenue Code allows a taxpayer to exclude

from gross income gain up to $250,000 or $500,000, if married filing jointly, from the sale of a personal residence.

D. Ownership and use tests. I.R.C. § 121(a).

1. General Rule. To exclude gain up to $250,000 or $500,000 (if married filing jointly), the taxpayer must meet the ownership and use tests. To do this, the taxpayer must have, during the 5-year period ending on the date of sale:

   a. Owned the home for at least 2 years (the ownership test); and

   b. Lived in the home as the main residence for at least 2 years (the use test).

2. Ownership and use for periods aggregating two years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 × 2).

   a. Two-year ownership and use periods need not be satisfied simultaneously nor during concurrent periods. A taxpayer may meet the homesale exclusion's ownership and use tests during different two-year periods as long as both tests are met during the five-year period ending on the date of the sale. Treas. Reg. § 1.121-1(c)(1).

3. In meeting the two-year use requirement, the taxpayer must occupy the home.

   a. Short temporary absences for vacations or other seasonal absences, even if the taxpayer rents out the property during the absences, are counted as periods of use. Treas. Reg. § 1.121-1(c)(2)(i).

   b. Two-month vacations are short temporary absences, but a one-year stay abroad (e.g., while on sabbatical) is not. Treas. Reg. § 1.121-1(c), Exs. (4) and (5).

4. Married filing jointly taxpayers qualify for the $500,000 exclusion if:

   a. Either spouse owned the property for periods aggregating two years or more during the five-year period ending on the date of the sale of the property;

   b. Both spouses used the property as a principal residence for periods aggregating two years or more during the five-year period ending on the date of the sale of the property; and

      (1) Use of the home need not have occurred while the spouses were married.

   c. Neither spouse used the home sale exclusion on a previous sale (or exchange) of a home during the two-year period ending on the sale date. I.R.C. § 121(b)(2); Treas. Reg. § 1.121-2(a)(3)(i).

5. Special circumstances.

   a. Joint owners who file separate returns. If taxpayers jointly own a principal residence, but file separate returns, each owner may exclude gain up to $250,000 attributable to his or her interest in the property, if the taxpayer otherwise meets the I.R.C. § 121 requirements. Treas. Reg. § 1.121-2(a)(2).

   b. A married couple may file a joint return and exclude up to $250,000 of gain from the sale or exchange or each spouse's principal residence provided that each spouse would be permitted to exclude up to $250,000 of gain if filing separate returns.

   c. If a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the previous two years, the newly married taxpayer is allowed a maximum exclusion of $250,000.

d. A "tacking" rule applies where one spouse owns the home, but transfers ownership to the other spouse. Namely, where an individual obtains a home from a spouse or former spouse under a transfer between spouses under I.R.C. § 1041(a) (including a transfer incident to divorce), the transferor's period of ownership carries over to the transferee. I.R.C. § 121(d)(3)(A), Treas. Reg. § 1.121-4(b)(1).

e. One spouse is awarded use of the home, but both still own it. Solely for purposes of the homesale exclusion, a person is treated as using a home as his principal residence during any period of ownership while the person's spouse or former spouse is granted use of the property under a divorce or separation instrument (as defined in I.R.C. § 71 (b)(2)). I.R.C. § 121(d)(3)(B), Treas. Reg. § 1.121-4(b)(2).

f. Surviving spouses.

(1) If the surviving spouse has not remarried, the period that the surviving spouse owned and used the property as a principal residence includes the period that the deceased spouse owned and used the property as a principal residence before death. I.R.C. § 121(d)(2); Treas. Reg. § 1.121-4(a)(1).

(2) Where the two-year ownership and use requirement is actually met (or deemed met) a surviving spouse who files a joint return with the deceased spouse for the year of death, and sells the home that year, may exclude up to $500,000 of gain if neither spouse had excluded gain from the sale of a principal residence during the two-year period ending on the date of the sale.

(3) Under I.R.C. § 121(b)(2), the $500,000 exclusion is available only if husband and wife make a joint return for the year of sale. If the home is sold in a later year. the surviving spouse may exclude only $250,000. Note, however, that the surviving spouse's receives a stepped-up basis in property received from the decedent.

g. Involuntary conversions. I.R.C. § 1033.

(1) Destruction, theft, seizure, requisition, or condemnation of a home is treated as a sale for purposes of the exclusion. I.R.C. § 121(d)(5)(A), Treas. Reg. § 1.121-3(d)(1).

(2) In determining the ownership and use tests for a principal residence, a taxpayer may include a period of time for a former home if that former home was involuntarily converted under I.R.C. § 1033 into that principal residence. I.R.C. § 121(d)(5)(C); Treas. Reg. § 1.121-4(d)(3).

h. Rollovers. I.R.C. § 1034.

(1) Under the homesale rollover rules of former I.R.C. § 1034 (repealed), generally effective for sales and exchanges after May 6, 1997, homesellers could defer gain on the sale of a principal residence if they timely reinvested the adjusted sales price (amount realized less fixing-up expenses) of the old residence in a replacement principal residence. The replacement period generally began two years before the sale of the residence and ended two years afterward.

(2) For purposes of the two-out of-five year ownership and use tests to qualify for current law's $250,000/$500,000 exclusion, a taxpayer whose purchase of a replacement residence resulted in deferral of gain under the rollover rules that applied to sales and exchanges before May 7, 1997 may "tack on" his ownership and use of the old residence to his ownership and use of the replacement residence. I.R.C. § 121(g); Treas. Reg. § 1.121-4(h).

E. What is a principal residence?

1. Whether property is used by the taxpayer as his residence depends on all the facts and circumstances. A taxpayer may use as his residence a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in I.R.C. § 216(b)(1), (b)(2)). Treas. Reg. § 1.121-1(b)(1).

2. If the taxpayer alternates between two residences, the property occupied the majority of the time ordinarily is the principal residence. Treas. Reg. § 1.121-1(b)(2).

3. Separation of home and surrounding land.

   a. A taxpayer who owns a home situated on a large lot or on substantial acreage may decide to sell off some of the land but to keep using the rest as his or her residence. Alternatively, the taxpayer may sell the home plus some acreage first and the balance of the vacant land later.

   b. Gain on the sale of the vacant land qualifies for the I.R.C. § 121 exclusion if:

      (1) The taxpayer otherwise qualifies for the exclusion;

      (2) The vacant land is:

         (a) Adjacent to the land containing the taxpayer's dwelling unit; and

         (b) Owned and used by the taxpayer as part of his principal residence for at least two of the five years preceding the sale; and

         (c) The dwelling unit is sold in a transaction qualifying for the homesale exclusion within two years before or two years after the sale

date of the vacant land. Treas. Reg. § 1.121-1(b)(3)(i).

(3) Only one maximum exclusion of $250,000 ($500,000 for qualifying joint filers) applies to the combined sales of the vacant land and dwelling unit.

F. Reduced Exclusion.

1. Taxpayers who fail to meet the ownership requirements or who have sold or exchanged principal residences within two years may qualify for a reduced exclusion. I.R.C. § 121(c)(2)(A), Treas. Reg. § 1.121-3.

2. Reduced exclusion amount.

a. The applicable dollar limitation (either $250,000 or $500,000);

b. Multiplied by ratio of:

(1) The shortest period of time where the ownership and use tests were met; and

(2) Two years (or 24 months or 730 days, as applicable).

3. The reduced exclusion applies to any sale or exchanges if:

a. The sale or exchange is because of a change in place of employment, health, or unforeseen circumstances [I.R.C. § 121(c)(2)(B); Treas. Reg. § 1.121-3(b)]; *and*

b. The exclusion (but for the reduced-exclusion rules) would <u>not</u> apply to the sale or exchange because of:

(1) Failure to meet the ownership and use requirements [I.R.C. § 121(c)(2)(A)(i)]; *or*

(2) Limit of only one sale every two years [I.R.C. § 121 (c)(2)(A)(ii)].

4. The regulations include specified safe harbors that automatically the above conditions.

a. Safe harbor: change in place of employment.

(1) A taxpayer qualifies for the partial exclusion if the primary reason for the sale is a change in the location of a qualified individual's employment. Treas. Reg. § 1.121-3(c)(1).

(a) A qualified individual is the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. Treas. Reg. § 1.121-3(f).

(2) The safe harbor requires two conditions:

(a) The individual's new place of employment is at least 50 miles farther from the residence sold than was the former place of employment.

(i) If there is no former place of employment, the new place of employment must be at least 50 miles from the residence sold.

(b) The change in place of employment occurs while the taxpayer owns and uses the home as his principal residence. Treas. Reg. § 1.121-3(c)(2).

b. Employment for purposes of the safe harbor includes beginning employment with a new employer, continuation of employment with the same employer, and beginning or continuation of self-employment. Treas. Reg. § 1.121-3(c)(3).

5. Safe harbor: change in health. Treas. Reg. § 1.121-3(d)(1).

a. Applies where the primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual; or

b. To obtain or provide medical, or personal care for a qualified individual suffering from a disease, illness, or injury.

c. A qualified individual includes the following: the taxpayer or the taxpayer's spouse; a co-owner of the residence; a person whose principal place of abode is in the same household as the taxpayer; or the taxpayer's family members listed in I.R.C. § l52(a)(1) through I.R.C. § 152(a)(8), even if not dependents. Treas. Reg. § 1.121-3(f).

6. Safe harbor: unforeseen circumstances.

a. Taxpayer sold home because of an event not anticipated before buying and occupying the home. Treas. Reg. § 1.121-3(e)(1).

(1) Involuntary conversion of the residence under I.R.C. § 1033;

(2) A natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence;

(3) Death of a qualified individual;

(4) Cessation of employment of a qualified individual making him or her ineligible for unemployment compensation;

(5) Change in employment or self-employment status of a qualified individual resulting in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household;

(6) Divorce or separation of a qualified individual under a decree of divorce or separate maintenance;

(7) Multiple births resulting from the same pregnancy of a qualified individual [Treas. Reg. § 1.121-3(e)(2)(E)]; or

(8) An event determined by the IRS to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer. *See, e.g.,* I.R.S. Notice 2002-60, 2002-36 I.R.B. 482 (9/11 terrorist attacks).

b. A qualified individual for purposes of the above events is the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. Treas. Reg. § 1.121-3(f).

7. If no safe harbor applies, factors that may be relevant in determining the primary reason for the sale or exchange include [Treas. Reg. § 1.121- 3(b)]:

a. The sale and the circumstances giving rise to it are close in time;

b. The suitability of the home as the taxpayer's principal residence materially changes;

c. The taxpayer's financial ability to maintain the home materially changes;

d. The taxpayer uses the home as his residence during the period that he owns the property;

e. The circumstances causing the sale are not reasonably foreseeable when he begins using the home as his principal residence; and

f. The circumstances causing the sale occur during the period that the taxpayer owns and uses the home as his principal residence.

G. Election out of gain exclusion.

1. A taxpayer may elect not to have the exclusion apply to a transaction that would otherwise be eligible for it. I.R.C. § 121(f).

2. The election is made by filing a return for the year of sale that includes the gain from the sale of the principal residence.

3. The election may be made (or revoked) at any time before the expiration of a 3-year period beginning on the original due date (i.e., without including extensions) for the year in which the sale occurred. Treas. Reg. § 1.121-4(g).

VI. SUSPENSION OF FIVE-YEAR HOMESALE EXCLUSION FOR QUALIFYING SERVICE MEMBERS

A. A Service member (as well Foreign Service and intelligence community personnel) may suspend for 10 years the five-year period of I.R.C. § 121(a) and (c)(1)(B) while serving on qualified official extended duty.

1. Qualified official extended duty: service at a duty station which is at least 50 miles from the property or while residing under Government orders in Government quarters. I.R.C. § 121(d)(9)(C)(i).

Example 1. C, a Navy officer, buys a residence in Florida on July 1, Year 1, and uses it as his principal residence until June 30, Year 2. On July 1, Year 2, C goes on qualified official extended duty in Japan until June 30, Year 8. At the end of this period, C returns to his Florida residence and uses it as his principal residence until July 30, Year 9. If C has made the election to suspend the five-year period and sells the residence on July 30, Year 9, the five-year period, for purposes of determining whether C is eligible for the exclusion, won't include the six years of his qualified official extended duty (i.e., from July 1, Year 2 until June 30, Year 8). Thus, C is eligible to claim an exclusion up to $250,000 because he used the residence for at least two years (from July 1, Year 1 until June 30, Year 2 and from July 1, Year 8 until

July 30, Year 9) in the relevant five-year period. (RIA Analysis of the Military Family Tax Act of 2003).

Example 2. The facts are the same as in illustration (1) except that C goes on qualified official extended duty until June 30, Year 14. On July 1, Year 14, C returns to his Florida residence and uses it as his principal residence until he sells the residence on July 2, Year 15. The maximum period of time that the five-year period can be suspended is ten years (i.e., until June 30, Year 12). The five-year period (as suspended) for determining whether C is entitled to the exclusion includes:

... July 1, Year 1 to June 30, Year 2, and
... July 1, Year 12 to July 2, Year 15.

During that period, C owned and used the residence as his principal residence from July 1, Year 1 to July 1, Year 2 (one year) and from July 1, Year 14 until July 2, Year 15 (one year and a day). Thus, any gain from the sale of C's principal residence is eligible for the up to $250,000 exclusion. (RIA Analysis of the Military Family Tax Act of 2003).

2. How the suspension affects the reduced exclusion**.**

a. The up-to-ten-year suspension also applies to the five-year period that applies for determining the amount of a reduced exclusion under I.R.C. § 121(c)(1)(B). I.R.C. § 121(d)(9)(A).

b. A sale of an individual's principal residence would still have to meet the requirements for the reduced exclusion (i.e., the sale is by reason of a change of place of employment, health, or unforeseen circumstances).

c. In most cases, a sale of a principal residence by an individual on *qualified official extended duty* (defined above) presumably would be considered a sale by reason of a change in place of employment and thus qualify for the reduced exclusion.

Example 1. D, a single member of the Marine Corps, buys a residence in California on Jan. 1, Year 1, and uses it as his principal residence until Dec. 31, Year 1. On Jan, 1, Year 2, D goes on qualified official extended duty in Europe until Dec. 31, Year 8. While on qualified official extended duty, D sells his California residence for a gain of $300,000 on Jan. 2, Year 8. The sale of D's California residence otherwise qualifies for a reduced exclusion as a sale by reason of a change in D's place of employment.

If D has elected to suspend the five-year period and otherwise qualifies for the reduced exclusion, D is eligible to exclude up to $125,000 of his gain (12/24 × $250,000) because during the relevant period, D owned and used the residence as a principal residence for one year (or twelve months).

Example 2. The facts are the same as in the illustration above except that D is on qualified official extended duty from Jan. 1, Year 2 until Dec. 31, Year 13. After his qualified official extended duty, D doesn't live in the California residence. D sells the California residence on Dec. 31, Year 15.

VII. GAIN RECOGNITION FROM SALE OF PRINCIPAL RESIDENCE

A. Nonqualified Use. The period of time during which the property was not used as a principal residence. I.R.C. § 121(b)(5)(C).

1. Occurs after December 31, 2008.

2. Does not include the portion of the five-year period ending on the date of sale after the date the property is last used as the principal residence.

3. Does not include any period (up to 10 years) during which the military member is serving on qualified official extended duty, which is active duty:

   a. For a period of more than 90 days or for an indefinite period;

   b. At a duty station at least 50 miles from the property;

   c. While living in government quarters under government orders.

4. Does not include any other period of temporary absence (up to 2 years) due to change of employment, health, or other unforeseen circumstances.

5. Gain is taxed in proportion the period of time attributable to nonqualified use. For example, if the taxpayer lives in another home for one year and lives in his or her main home for the other four years, 20% of the gain (1 year ÷ 5 years) from the main home is taxable.

B. Introduction: Sale of rental property, which does not qualify for capital gain exclusion under I.R.C. § 121, is generally treated as the sale of business property. The gain from the sale of business property is taxable to the seller as income.

C. Ordinary or Capital Gain or Loss for Business Property

1. When the taxpayer disposes of business property, the taxable gain or loss is usually a section 1231 gain or loss. Its treatment as ordinary or capital is determined under rules for section 1231 transactions.

2. When the taxpayer disposes of depreciable property (Section 1245 property or Section 1250 property) at a gain, he may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules.

D. Modified Accelerated Cost Recovery System (MACRS). Property depreciated after 1986 is depreciated using the Modified Accelerated Cost Recovery System (MACRS). Gain from property sold after being depreciated under MACRS is divided into two components and taxed at two different rates:

1. The portion of the gain attributable to "straight line" depreciation is generally taxed as unrecaptured I.R.C. § 1250 property at a 25% tax rate.

2. The remaining gain, normally attributable to appreciation, is taxed at the long-term capital gains rates of 0%, 15%, or 20%.

E. Depreciation Recapture.

1. If the taxpayer disposes of depreciable or amortizable property at a gain, he may have to treat all or part of the gain (even if otherwise nontaxable) as ordinary income.

a. To figure any gain that must be reported as ordinary income, the taxpayer must keep permanent records of the facts necessary to figure the amount of depreciation or amortization allowed or allowable on the property. This includes the date and manner of acquisition, cost or other basis, depreciation or amortization, and all other adjustments that affect basis.

b. On property acquired in a nontaxable exchange or as a gift, the records must also indicate the following information.

(1) Whether the adjusted basis was figured using depreciation or amortization you claimed on other property.

(2) Whether the adjusted basis was figured using depreciation or amortization another person claimed.

F. Like-Kind Exchanges. I.R.C. § 1031.

1. Gain is taxable where the taxpayer:

a. The taxpayer acquired the home in a like-kind exchange, and

b. The home was sold:

(1) After October 22, 2004; and

(2) During the 5-year period beginning with the date the taxpayer acquired the home.

G. Mixed use of home for personal and business/rental purposes.

1. If a home that was mixed-use (residence and non-residence) property is not used entirely as a principal residence for at least two of the five years ending on the sale date, gain exclusion depends on where the non-residence use of the property took place:

a. If the non-residence use of the property took place <u>within the dwelling unit</u>, all of the gain (except for the gain representing post-6 May 97 depreciation) is eligible for the home sale exclusion.

b. If the non-residential use of the property took place <u>outside of the dwelling unit</u>, then only the gain attributable to the dwelling-unit portion is eligible for the home sale exclusion. Treas. Reg. § 1.121-1(e)(1).

2. Non-residence use within the dwelling unit. A professional such as an attorney, accountant, or doctor may use part of his home for

business purposes, or the owner of a multi-story home may rent out a floor and use the balance of the property as his residence. If the entire property is used as a principal residence for at least two of the five years preceding the sale, and the other I.R.C. § 121 conditions are met, the home sale exclusion applies to all of the gain except that part of the gain attributable to post-6 May 97 depreciation. I.R.C § 121(d)(6).

a. Example. Example: Dianne Davis, an attorney, buys a house in 20X1. The house constitutes a single dwelling unit but Davis uses part of it (e.g., one of the bedrooms or a den) as a law office. Davis claims depreciation deductions of $2,000 during the period that she owns the house. She sells the house in 20X4, realizing a gain of $13,000. She has no other I.R.C § 1231 or capital gains or losses for 2006. Davis must recognize $2,000 of the gain as unrecaptured I.R.C § 1250 gain taxed at rates up to 25%. She may exclude the remaining $11,000 of gain from the sale of her house because she doesn't have to allocate gain to the business use within the dwelling unit. Treas. Reg. § 1.121-1(e)(4), Ex. 5.

b. Under I.R.C § 280A(c)(1), depreciation deductions for business use of a dwelling unit are available only if part of the dwelling unit is used regularly and exclusively as the principal place of a taxpayer's trade or business, or as a place to meet or deal with clients or customers in the ordinary course of the taxpayer's business. If a taxpayer's business use of a dwelling unit doesn't satisfy these conditions (e.g., a room is used during the day for business and as a family den in the evenings), depreciation deductions can't be claimed and all of the gain from its sale may be eligible for the home sale exclusion.

c. Example. The facts are the same as in the immediately previous example, except that Davis is not entitled to claim any depreciation deductions for her business use of the house. Davis may exclude the entire $13,000 of gain from the sale of her house. Treas. Reg. § 1.121-1(e)(4), Ex. 6.

3. Non-residence use outside the dwelling unit.

a. Gain on the sale of a mixed-use home must be allocated between the residence and non-residence portions.

b. Only the gain attributable to the principal-residence-portion of the property (the portion used as a principal residence for at least two of the five years ending with the sale date) may be excluded under I.R.C § 121. Treas. Reg. § 1.121-1(e)(1).

c. Example. In 2016, Arturo Acela sells a property that consists of a house, a stable and 35 acres. He used the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. Acela uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after 6 May 97, Acela claims depreciation deductions of $9,000 for the non-residential use of the stable. He realizes a gain of $24,000 on the sale of the property and has no other I.R.C § 1231 or capital gains or losses for 2016. Acela must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. He determines that $14,000 of the gain is allocable to the non-residential- use portion of the property and that $10,000 of the gain is allocable to the residence portion of the property. Acela must recognize $14,000 of gain ($9,000 of which is unrecaptured I.R.C § 1250 gain taxed at 25%, and $5,000 of which is adjusted net capital gain, which is taxed at 20% if Acela's other taxable income is taxed at a 25% or higher rate). Acela may exclude $10,000 of the gain from the sale of the property. Treas. Reg. § 1.121-1(e)(4), Ex. 1.

4. Allocating gain.

a. To determine the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate basis and amount realized between the residential and the non-residential portions using the same method of allocation he used to determine depreciation adjustments. Treas. Reg. § 1.121-1(e)(3). In other words, the gain allocation is based not on relative values at the

time of sale but on relative values when the taxpayer began depreciating the non-residential portion of the property

b. To determine the depreciable portion of a property used partially for business or rental purposes from the time it was purchased, a taxpayer must first allocate the purchase price between the improvements and the land. This allocation generally is based on the ratio of the depreciable improvements' value at acquisition to the entire property's value at that time. Treas. Reg. §§ 1.167(a)-5, 1.167(a)-5T. The taxpayer also would have to allocate the overall value of the improvements between the residential and nonresidential portions.

c. When a property used entirely as a residence is converted to business or rental use, then for purposes of calculating losses or depreciation (but not for purposes of calculating gain) the basis for the property on the date of its conversion is the lower of its adjusted basis or fair market value on that date. Treas. Reg. § 1.167(g)-1. This rule would also apply to the non-residence portion of a home that is converted to partial business or rental use.

H. Reporting the Gain

1. Do not report the sale of a main home on the taxpayer's tax return unless:

a. The taxpayer has a gain and does not qualify to exclude all of it,

b. The taxpayer has a gain and chooses not to exclude it, or

c. The taxpayer receives a Form 1099-S in connection with the transaction.

2. If there is any taxable gain on the sale of the main home that cannot be excluded, report the entire gain realized on Form 8949 and Schedule D (Form 1040).

3. Report the taxable gain on the non-residential, business portion of the home on Form 4797.

VIII. EXAMPLES – PARTIAL EXCLUSION OF GAIN

A. Qualifying under I.R.C. § 121. Owned and occupied at time of sale after a period of rental. No business or rental use in the year of sale. Reporting nonqualified use and post-6 May 97 depreciation. The 2013 version of Pub. 523 included a comprehensive example of a home sale, upon which the following is based. **This example is included for illustration purposes only** and should not be assumed to reflect current law.

- Illustrated Example -

Emily White, a single person, bought a home on May 1, 2001. She lived in the home until May 31, 2011, when she moved out and put it up for rent. Emily rented her home from June 1, 2011, until May 31, 2012. She moved back into the house and lived there until she sold it on January 11, 2013.

Emily can exclude gain on the sale of her home because she owned and lived in the home for at least 2 years of the 5-year period ending on the date of the sale.

Emily's records show the following:

1) Original cost	$ 50,000
2) Legal fees for title search	750
3) Back taxes paid for prior owner	1,500
4) Improvements (deck)	2,000
5) Selling price	195,000
6) Commission and expenses of sale	15,000
7) Depreciation claimed after May 6, 1997	1,791

Emily uses Worksheet 1 [Pub 523] to figure the adjusted basis of the home she sold ($52,459). She uses Worksheet 2 [Pub 523] to figure the gain on the sale ($127,541), the amount of her taxable gain ($12,480) and the amount of her exclusion ($115,061).

Emily taxable gain of $12,480 comprises: (*i*) $1,791, the part of her gain equal to the depreciation deduction claimed while the house was rented; and (*ii*) $10,689, the amount of her gain from nonqualified use.

Emily reports the sale in Part II of Form 8949 and Part II of Schedule D (Form 1040). On her Form 8949, Part II, she reports her selling price of $195,000 in column (d) and her adjusted basis of $52,459 in column (e). In column (g), she reports the sum of her exclusion and her selling expenses ($130,061) as a negative number.

She enters $1,791 on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the Schedule D (Form 1040) instructions. She has no gains or losses from the sale of property other than the gain from the sale of her home. Therefore, she also enters $1,791 on lines 13 and 18 of the worksheet and on line 19 of Schedule D. She then figures her tax using the Schedule D Tax Worksheet in the Schedule D (Form 1040) instructions

Emily's completed *Worksheets* 1 & 2, her Schedule D, and her *Unrecaptured Section 1250 Gain Worksheet* follow.

Worksheet 1. Adjusted Basis of Home Sold—Illustrated Example 3 for Emily White

Keep for Your Records

Caution: *See the Worksheet 1 Instructions before you use this worksheet.*

1.	Enter the purchase price of the home sold. (If you filed Form 2119 when you originally acquired that home to postpone gain on the sale of a previous home before May 7, 1997, enter the adjusted basis of the new home from that Form 2119.)		1.	$50,000
2.	Seller-paid points for home bought after 1990 (see *Seller-paid points*). Do not include any seller-paid points you already subtracted to arrive at the amount entered on line 1		2.	
3.	Subtract line 2 from line 1		3.	50,000
4.	Settlement fees or closing costs (see *Settlement fees or closing costs*). If line 1 includes the adjusted basis of the new home from Form 2119, skip lines 4a–4g and 5; go to line 6			
a.	Abstract and recording fees	4a.		
b.	Legal fees (including fees for title search and preparing documents)	4b. 750		
c.	Survey fees	4c.		
d.	Title insurance	4d.		
e.	Transfer or stamp taxes	4e.		
f.	Amounts that the seller owed that you agreed to pay (back taxes or interest, recording or mortgage fees, and sales commissions)	4f. 1,500		
g.	Other	4g.		
5.	Add lines 4a through 4g		5.	2,250
6.	Cost of additions and improvements. Do not include any additions and improvements included on line 1		6.	2,000
7.	Special tax assessments paid for local improvements, such as streets and sidewalks		7.	
8.	Other increases to basis		8.	
9.	Add lines 3, 5, 6, 7, and 8		9.	54,250
10.	Depreciation allowed or allowable, related to the business use or rental of the home	10. 1,791		
11.	Other decreases to basis (see *Decreases to Basis*)	11.		
12.	Add lines 10 and 11		12.	1,791
13.	**Adjusted basis of home sold.** Subtract line 12 from line 9. Enter here and on Worksheet 2, line 4		13.	$52,459

Worksheet 2. Taxable Gain on Sale of Home—Illustrated Example 3 for Emily White

Keep for Your Records

Part 1. Gain or (Loss) on Sale

1.	Selling price of home	1.	$195,000
2.	Selling expenses (including commissions, advertising and legal fees, and seller-paid loan charges)	2.	15,000
3.	Subtract line 2 from line 1. This is the amount realized	3.	180,000
4.	Adjusted basis of home sold (from Worksheet 1, line 13)	4.	52,459
5.	**Gain or (loss)** on the sale. Subtract line 4 from line 3. If this is a loss, stop here	5.	127,541

Part 2. Exclusion and Taxable Gain

6.	Enter any depreciation allowed or allowable on the property for periods after May 6, 1997. If none, enter -0-	6.	1,791
7.	Subtract line 6 from line 5. If the result is less than zero, enter -0-	7.	125,750
8.	Aggregate number of days of nonqualified use after 12/31/2008	8.	365
9.	Number of days taxpayer owned the property	9.	4,273
10.	Divide the amount on line 8 by the amount on line 9. Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.00	10.	.085
11.	Gain allocated to nonqualified use. (Line 7 multiplied by line 10)	11.	10,689
12.	Gain eligible for exclusion. Subtract line 11 from line 7.	12.	115,061
13.	If you qualify to exclude gain on the sale, enter your maximum exclusion (see *Maximum Exclusion*). If you qualify for a reduced maximum exclusion, enter the amount from Worksheet 3, line 7. If you do not qualify to exclude gain, enter -0-	13.	250,000
14.	**Exclusion.** Enter the smaller of line 12 or line 13	14.	115,061
15.	**Taxable gain.** Subtract line 14 from line 5. Report your taxable gain as described under *Reporting the Sale*. If the amount on this line is zero, do not report the sale or exclusion on your tax return. **If the amount on line 6 is more than zero, complete line 16**	15.	12,480
16.	Enter the **smaller** of line 6 or line 15. Enter this amount on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D (Form 1040)	16.	$1,791

B. Qualifying under I.R.C. § 121. Owned and occupied, but with partial business use at the time of sale. Reporting business gain/loss and post-6 May 97 depreciation.

1. The Code Sec. 121 exclusion does *not* apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property was used for non-residential purposes, only the gain allocable to the residential portion is excludable from gross income under I.R.C. § 121. Treas. Reg. § 1.121-1(e)(1).

2. Allocation is *not* required, however, where both residential and non-residential occurs <u>within</u> the "dwelling unit," as defined under I.R.C. § 280A(f)(1). Treas. Reg. § 1.121-1(e)(1), (e)(2).

3. In addition, if the depreciation for periods after 6 May 97 attributable to the non-residential portion of the property (see below) exceeds the gain allocable to the non-residential portion of the property, the excess does not reduce the I.R.C § 121 exclusion applicable to the gain allocable to the residential portion of the property. T.D. 9030, 2003-1 C.B. 495, 496 (Dec. 23, 2002); Treas. Reg. § 1.121-1(e)(4), Ex. 5.

4. Where a taxpayer sells the entire property and non-residential use occurs *outside* the dwelling, he or she treats the transaction as the sale of two properties. The sale of the portion of the property used for business or rental is reported on Form 4797.

5. To report the sale properly on Form 4797, the taxpayer must allocate the selling price, selling expenses, and basis between the part used for business or rental and the part used as a home. If the taxpayer qualifies to exclude any gain on the business or rental part of the home, he divides his maximum exclusion between that part of the property and the part used as a home. Treas. Reg. § 1.121-1(e)(4), Ex. 1.

6. The example that follows depicts the method of allocation appropriately where business use occurred <u>outside</u> of the dwelling unit.

- 2013 Pub. 523, Example 5 -

In January 2008, you bought and moved into a 4-story townhouse. In December 2010, you converted the basement level, which has a separate entrance into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that led from the basement to the upper floors. After you completed the conversion, your townhouse had a rental unit that was separate from the part of your house used as your home. You lived in the first, second, and third levels of the townhouse and rented the basement level to tenants until December 2012. You claimed depreciation deductions of $2,000 for the basement apartment. You sold the entire townhouse in December 2008 for a $16,000 gain. Your records show the following:

Purchase price	$ 96,000
Depreciation (on business part)	2,000
Improvements	4,000
Selling price	124,000
Selling expenses	10,000

Because you meet the ownership and use tests for the entire house, you can claim the exclusion for both the home and business parts. You start by finding the adjusted basis of each part. You determine that three-fourths (75%) of your purchase price was for the part used as your home; one-fourth (25%) was for the part used for business.

	Personal (3/4)	Business (1/4)
Purchase price	$72,000	$24,000
Improvements		4,000
Minus: Depreciation	-0-	2,000
Adjusted basis	$72,000	$26,000

Next, you figure the gain on each part, dividing your selling price and selling expenses between the two parts.

	Personal (3/4)	Business (1/4)
Selling price	$93,000	$31,000
Minus: Selling expenses	7,500	2,500
	82,500	28,500
Minus: Adjusted basis	72,000	26,000
Gain	$13,500	$2,500

Then, to figure your taxable gain and exclusion on each part, you decide to fill out a separate Worksheet 2 (Part 2) [Pub 523] for each part, dividing your maximum exclusion between the two parts. You are single, so your maximum exclusion is $250,000.

	Personal (3/4)	Business (1/4)
Part 2-Exclusion and Taxable Gain		
6) Depreciation after May 6, 1997	$ -0-	$ 2,000
7) Subtract line 6 from gain	13,500	500
8) Maximum exclusion	$187,500	$62,500
9) Exclusion (Smaller of line 7 or line 8)	13,500	500
10) Taxable gain (gain minus line 9)	-0-	*
11) Smaller of line 6 or line 10	-0-	*

NOTE: * Lines 10 and 11 do not need to be filled out for the business part.

The gain from the part used as your home does not have to be reported on your return, because you can exclude all of it. You report the gain from the business part ($3,500) in Part III of Form 4797. You enter your exclusion ($500) as a loss on line 2, column (g) of Form 4797. Your taxable gain from the business part is $2,000 ($2,500 − $500).

C. Qualifying under I.R.C. § 121. Owned and vacated, held out as a rental at time of sale. Reporting business gain/loss and post May 6, 1997 depreciation.

1. Fact pattern:

Example:

Own & occupy – Vacate & Rent – Sell

Example. On May 30, 20X1, CPT Amy Smith bought a house. She moved in on that date and lived in it until May 31, 20X3, when she moved out of the house pursuant to PCS orders and put it up for rent. The house was rented from June 1, 20X3, until she sold it on January 31, 20X7. During the 5-year period ending on the date of the sale (February 1, 20X2 – January 31, 20X7), CPT Amy owned the house for 5 years, but only lived in it for 16 months. CPT Amy's move was due to a change in place of employment and qualifies for the reduced exclusion under I.R.C. § 121(c)(2)(B).

Five Year Period	Used as Home	Used as Rental
2/1/X2 - 5/31/X3	16 months	
6/1/X3 - 1/31/X7		44 months
	16 months	44 months

Amy can exclude gain up to $166,667 of gain. However, she cannot exclude the part of the gain equal to the depreciation she claimed for renting the house after May 6, 1997.

1. If the taxpayer used the home to produce rental income during the year of sale, the taxpayer must use Form 4797, Sale of Business Property, to report the sale of the business of rental part of the (or the sale of the entire property if used entirely for business or rental in the year of sale). Pub. 523.

a. If the property was used for business or to produce rental income and was also owned and used as the taxpayer's home during the 5-year period ending on the date of sale, the taxpayer may be able to exclude part of all of the gain figured on Form 4797.

b. Property held more than one year.

(1) Complete Part III of Form 4797 to determine the gain.

(2) Do not take the exclusion arising from I.R.C. § 121 into account when determining the gain on of Form 4797.

(3) If the depreciation entered on Form 4797 includes depreciation taken for periods after 6 May 97, the taxpayer cannot exclude gain to the extent of such depreciation.

(4) Enter "Section 121 Exclusion" on Form 4797 and enter the amount of the exclusion as a loss.

c. Property held less than one year. Report the sale and amount of the exclusion, if any, in a similar manner on the applicable line of Form 4797.

d. For example, see previous example. Report in a similar fashion using Form 4797, Form 8949, and Form 1040, Schedule D.

IX. GAINS AND LOSSES FROM TRANSACTIONS IN DEPRECIABLE PROPERTY

A. Section 1231, 1245, and 1250 transactions are normally beyond the scope of military tax programs. These topics are briefly described below

because a sale of a principal residence might affect the treatment of such transactions.

B. Section 1231 Gains and Losses. These include gains and losses from depreciable property and real property used in a trade or business, including for rental use.

1. The treatment of Section 1231 gains and losses as ordinary or capital depends on whether there is net gain or a net loss from all Section 1231 transactions.

2. Section 1231 transactions include:

a. Sales or exchanges of real property or depreciable personal property. This property must be used in a trade or business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business.

b. Condemnations.

c. Casualties and thefts, if related to business or rental property held for more than one year.

C. Treatment as Ordinary or Capital.

1. Net all Section 1231 gains and losses for the year.

2. If the netting results in a loss, it is an ordinary loss.

3. If the netting is gain, the gain is capital.

a. Exception: the result is ordinary income up to the amount of unrecaptured Section 1231 losses for the five previous years.

4. Section 1245 Property**.**

   a. A gain on the disposition of Section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property.

   b. Any gain recognized that is more than the part that is ordinary income from depreciation is a Section 1231 gain.

   c. Generally, Section 1245 property includes personal property (either tangible or intangible) that is or has been subject to an allowance for depreciation or amortization.

   d. Section 1245 property does not include buildings and structural components.

5. Section 1250 Property.

   a. Gain on the disposition of Section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. Because real estate is depreciated using the straight-line method, additional depreciation is uncommon and beyond the scope of this outline.

   b. Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and never has been Section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable.

X. TRANSACTIONS THAT DEFER OR AVOID GAIN

A. Like-Kind Exchange. Under I.R.C. § 1031, no gain or loss is recognized when real property held for productive use in a trade or business or for investment is exchanged for property of a like kind.

1. Almost any exchange of real estate held for business or investment qualifies as like-kind property. For example, an exchange of a store for an apartment building would qualify.

2. If the taxpayer receives something of value that doesn't qualify for like-kind treatment, any gain resulting from the transaction is taxable (to the extent of the value of the non-qualifying property) but any loss resulting from the transaction is not recognizable.

3. Qualified intermediary. Taxpayers may transfer and receive property through a qualified intermediary (e.g., a real estate broker who locates and acquires like-kind property for the exchange) and still qualify for nonrecognition treatment.

   a. A direct sale of property followed by a purchase of property of a like-kind never qualifies for nonrecognition of gain or loss under Section 1031.

   b. Taxpayers may transfer property to a real estate broker and the real estate broker may acquire property for the taxpayer, transfer the property to the taxpayer, and the transaction will qualify for like-kind treatment. Treas. Reg. §1.1031(k)-1(g)(4); see also Pub. 946.

XI. CONCLUSION

CHAPTER L

CASUALTY & DISABILITY TAX ISSUES

TABLE OF CONTENTS

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

I. REFERENCES

A. Internal Revenue Code (I.R.C.), §§ 104, 112, 692, 6511, 6513, 7503, 7508.

B. Treasury Regulations. (Treas. Reg.).

C. Revenue Rulings (Rev. Rul.): 69-301, 2003-41.

D. IRS Publications:

1. Pub. 3, Armed Forces' Tax Guide.

2. Pub. 17, Your Federal Income Tax.

3. Pub. 559, Survivors, Executors, and Administrators.

E. IRS Forms 1040 & 1310.

II. FILING REQUIREMENT

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

1. File a return for the year of death.

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

3. Example: SFC Samantha Smith died on March 14, 20X2 before filing her 20X1 return. Her 20X1 return is still due 15 April 20X2 and her final return is due 15 April 20X3 for the 20X2 tax year.

B. Who files the returns?

1. The personal representative, if one is appointed.

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

3. May need to complete Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, if not the surviving spouse or a court-appointed personal representative. (The court-appointed personal representative must attach the court certificate, e.g., Letter Testamentary).

III. FILING STATUS

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

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

C. A surviving spouse, who remains unmarried, can use qualifying widow(er) filing status for up to 2 years after the year of death if he or she has a dependent child. This filing status entitles the survivor to MFJ tax rates and higher standard deduction (the survivor does not itemize).

IV. GENERAL PRINCIPLES

A. Exemptions and Deductions. Generally, the rules that apply to an individual apply the same to the decedent's final return, even if the return covers less than 12 months. For example,

1. The final return can claim the standard deduction applicable to the decedent's filing status or can itemize deductions, including by claiming deductions paid by the decedent prior to death.

2. The decedent's final return can claim the Earned Income Tax Credit.

3. The decedent's final return can claim an applicable Child Tax Credit or Additional Child Tax Credit.

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

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

C. Finishing the Return.

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

2. If the decedent is a Service member who died in a combat zone, then at the top of the return put "KIA" and the combat zone where the death occurred (e.g., "Enduring Freedom–KIA") or the injury/disease leading to the death occurred instead of "Deceased."

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

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

D. Signing the return.

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

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

E. Filing the Return.

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

2. For service members killed in a combat zone claiming tax forgiveness (see below), file a paper return with the Internal Revenue Service at 333 W. Pershing, P5-6503, Kansas City, MO 64108.

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

V. TAX FORGIVENESS FOR COMBAT DEATHS

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

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

2. A combat zone is any area that the President, by executive order, designates as an area in which Armed Forces of the United States are or have engaged in combat. I.R.C. § 112. Qualified hazardous duty areas are treated as combat zones during the periods that

members of the Armed Forces are entitled to special pay for duty in a hostile area under 37 U.S.C. § 310.

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

B. Joint Returns and Forgiveness.

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

2. Must allocate tax liability between the service member and spouse pursuant to a formula for years where a spouse has income and the abatement is claimed for the decedent under I.R.C. § 692.

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

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

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

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

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

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

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

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

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

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

D. Determining the Statute of Limitations.

1. As discussed in Chapter A, I.R.C. Section 6511(a) provides that a claims for refund must be filed within three years from the filing date of the original return or within two years date of payment of tax, whichever is later.

2. I.R.C. Section 7508(a)(1)(E) provides an automatic extension to file a claim for refund for the period that the Service member is in the combat zone, and for the next 180 days thereafter.

3. I.R.C. §§ 692, 6511, and 7508 all apply to prior year claims for refunds. The surviving spouse or personal representative should file amended returns for all years that are still open, which may require careful analysis. For a comprehensive example, see I.R.S. C.C.A. 200447035 (Aug. 16, 2004). The taxpayer at issue served in combat zones at various times from 1 January 20X1 until his death on March 23, 2X12. The surviving spouse's amended

returns filed before 15 April 2X14 constituted timely claims for refund of taxes for six years (20X7 through 2X13) were timely because of the suspension of the limitations period for all time served in a combat zone and for 180 days thereafter.

VI. SURVIVOR ISSUES

A. Survivor Benefit Plan (SBP).

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

2. SBP is offset, dollar for dollar, by Dependency Indemnity Compensation (DIC) paid by the Department of Veterans Affairs. The Special Survivor Indemnity Allowance (SSIA) partially reduces the impact of the offset; paying $310 per month (adjusted annually for inflation beginning in 2019).

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

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

5. If a child is receiving SBP it is still taxable and is taxable on the child's return. The amount of unearned income and the standard deduction for taxpayers who may be claimed as a dependent on someone else's tax return fluctuates annually. Consult IRS Publication 501 to determine the filing requirement and standard deduction amount for dependents with unearned income for the current tax year.

B. Social Security Survivor Benefits.

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

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

    b. If a surviving spouse under his full retirement age earns more than an annual threshold amount, he or she will have the widow(er) benefit reduced. The amount of the reductions is $1 deducted for every $2 dollars earned above the annual threshold.

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

3. Social Security benefits may be taxable. Generally, SS benefits are not taxable if the individual's "provisional income" (which is AGI adjusted for certain items) is: (i) under $25,000 for individuals filing single, head of household, or as a qualifying widow(er); or (ii) under $32,000 if married filing jointly.

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

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

VII. DISABILITY PAYMENT ISSUES

A. Offset of Military Retirement by VA Disability

1. Military retirement pay is includable in gross income and taxable. *See, e.g., Eatinger v. Commissioner*, T.C. Memo 1990-310 ("A military retirement pension, like other pensions, is simply a right to receive a future income stream from the retiree's employer.").

2. In contrast, disability payments for personal injuries or sickness resulting from active service in the armed forces are not taxable if the payment is due to a combat related injury, as defined by I.R.C. § 104(b)(3), or if the Servicemember would be entitled to disability compensation from the VA for that injury. I.R.C. § 104(a)(4).

3. If the taxpayer's combined disability rating is 40% or lower, and they do not have a combat related disability, then military retirement income is offset by the amount of VA disability payments.

4. If a taxpayer initially receives military retirement pay, and is then subsequently awarded VA disability that causes the military retirement pay to be offset, the taxpayer may file amended returns for all open tax years (generally three years, although potentially more due to combat zone filing extensions, etc) to treat the offset portion of military retired pay as non-taxable income. *See, e.g., St. Clair v. United States*, 778 F.Supp. 894; Action on Decision 1992-006; *Keeter v. Comm'r*, T.C. Summ. Op. 2017-36.

B. Combat Injured Veterans Tax Fairness Act

1. The Combat Injured Veterans' Tax Fairness Act of 2016 (CIVTFA) (Pub. L. No. 114-292) allows combat wounded veterans who received disability severance pay from 1991 – 2016 to seek income tax refunds outside of the normal three-year statute of limitations.

2. In July 2018, DFAS began the process of notifying potentially affected taxpayers, by mailing letters through the IRS. Under the

CIVTFA, the taxpayer has one year from the date of the letter (or, if longer, the normal statute of limitations) to file a claim for refund. (See https://www.dfas.mil/dsp_irs.)

3. Refunds may be obtained by filing amended income tax returns (IRS Form 1040X), for the tax year in which the disability severance payment was received. "Veteran Disability Severance" or "St. Clair Claim" should be written across the top of the front page of the Form 1040X. A copy of the letter received from the IRS on behalf of DFAS should be enclosed, and an explanation of why the disability severance payment was not taxable should be provided in Part III of Form 1040X.

4. Refunds may be calculated in one of two ways:

   a. The taxpayer may seek a refund of the actual amount of excess income tax paid. In order to do this, the taxpayer must have the necessary documentation to amend their original income tax return. Specifically, the IRS requires the following to be attached to the amended return:

      (1) Documentation showing the exact amount of and reason for the disability severance payment, such as a letter from the Defense Finance and Accounting Services (DFAS) explaining the severance payment at the time of the payment or a Form DD 214, and

      (2) The VA determination letter confirming the disability or a determination that the injury or sickness was either incurred as a direct result of armed conflict, while in extra-hazardous service, or in simulated war exercises, or was caused by an instrumentality of war.

   b. The taxpayer may claim a standard refund amount. Instead of providing specific documentation, the taxpayer initiates an amended return (IRS Form 1040X) and writes "Disability Severance Pay" on line 15. The taxpayer then enters the standard refund amount on line 15, column B, and on line 22. The remaining lines on the Form 1040X are left blank. The standard refund amounts are:

(1) $1,750 for tax years 1991–2005

(2) $2,400 for tax years 2006–2010

(3) $3,200 for tax years 2011–2016.

VIII. CONCLUSION

CHAPTER M

DEPLOYMENT TAX ISSUES

TABLE OF CONTENTS

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

I. REFERENCES

A. I.R.C. §§ 112, 6081, 7508.

B. 10 U.S.C. § 101(a)(13).

C. Treas. Reg. §§ 1.112-1, 1.6081-4, 1-6081-5.

D. Pub. L. Nos. 104-117, 106-21, 114-292, 115-97.

E. Executive Order Nos. 12744, 13119, 13239.

F. DoD Regulation 7000.14-R, Financial Management Regulation (DOD FMR), Volume 7a.

G. Pub. 3, Armed Forces' Tax Guide.

H. Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.

II. QUALIFYING FOR COMBAT ZONE TAX BENEFITS

A. Combat Zone (CZ). A combat zone is an area that the President of the United States has designated by Executive Order as an area where US forces are engaged in combat. A combat zone remains in effect until terminated by Executive Order. I.R.C. § 112(c)(2). The current combat zones are as follows:

1. Executive Order 12744 designates the Persian Gulf, Red Sea, Gulf of Oman, Gulf of Aden, the Arabian Sea north of 10 degrees north latitude and west of 68 degrees east longitude, Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates and the airspace above these locations as a combat zone effective 17 January 1991.

2. Executive Order 13119 designates the former Federal Republic of Yugoslavia (Serbia/Montenegro), Albania, the Adriatic Sea, the Ionian Sea north of the 39th parallel and the airspace above these locations as a combat zone effective 24 March 1999.

3. Executive Order 13239 designates Afghanistan, including the airspace above, as a combat zone effective 19 September 2001.

B. Qualified Hazardous Duty Area (QHDA). A QHDA is an area that Congress has designated through legislation where the Armed Forces are entitled generally to the same benefits afforded service in a combat zone under I.R.C. § 112.

1. In December 2017, Congress designated the Sinai Peninsula as a QHDA, effective 9 June 2016. Pub. L. No. 115-97, § 11026 (Dec. 22, 2017).

2. There are also two QHDAs relating to conflicts in the former Yugoslavia. Pub. L. No. 104-117, 110 Stat. 827 (Mar. 20, 1996) (service in Bosnia and Herzegovina, Croatia, or Macedonia, effective 21 November 1995); Pub. L. No. 106-21, 113 Stat. 34 (Apr. 19, 1999) (Serbia/Montenegro, Albania, the Adriatic Sea, the Ionian Sea north of the 39th parallel, effective 24 March 1999).

3. The above QHDAs make benefits contingent on entitlement to imminent danger or hostile fire pay under 37 U.S.C. § 310. Imminent danger/hostile fire pay has been authorized in the Sinai Peninsula since 29 January 1997. As of the date of this revision, imminent danger/hostile fire pay is no longer authorized in the two QHDAs in the former Yugoslavia.

4. Imminent danger/hostile fire pay locations are listed in figure 10-1, Volume 7a, DOD FMR.

C. Entitlement to CZ Benefits

1. Generally, to receive CZ tax benefits, a member must serve in a CZ, or in a QHDA or direct support area and receive hostile fire or imminent danger pay. Treas. Reg. § 1.112-1. The service must be performed on or after the date designated in the Executive Order as the commencement date of combat activities and on or before the designated termination date of such activities (or, for a QHDA, under the conditions specified in the legislation). I.R.C. § 112(c)(3).

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

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

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

3. "In Direct Support."

a. The Secretary of Defense has the authority under Treasury Regulation 1.112-1 (currently delegated to PDUSD(P&R)) to extend combat zone tax exclusion benefits (CZTE) to service members performing military service <u>outside</u> of a combat zone or qualified hazardous duty area when the Secretary of Defense determines:

(1) Their service directly (as opposed to remotely or indirectly) supports military operations in the combat zone;

(2) Their service qualifies them for hostile fire pay or imminent danger pay under 37 U.S.C. § 310; and

(3) The reason for paying imminent danger/hostile fire pay is based on risks/dangers related to the QHDA or CZ.

b. Direct support areas are listed in Figure 44-1, Volume 7a, DOD FMR.

4. Service members are not eligible for CZ tax benefits if:

a. Present in a CZ while on leave from a duty station outside the CZ;

b. They simply pass over or through a CZ during the course of a trip between two points outside a CZ; or

c. Present in a CZ solely for their own personal convenience. Treas. Reg. § 1.112-1(f).

D. Current CZs and QHDAs. Current Recognized Combat Zones, https://www.irs.gov/newsroom/combat-zones. See also Pub. 3.

1. Sinai Peninsula. Pub. L. No. 115-97, § 11026 (Dec. 22, 2017).

2. Afghanistan Area, Executive Order 13239 (19 Sep 01):

a. Afghanistan, under the terms of the order.

b. "Direct support" regions designated by Secretary of Defense:

(1) Jordan, Kyrgyzstan, Pakistan, Tajikistan, and Uzbekistan (as of 19 Sep 01);

(2) Philippines (09 Jan 02 – 30 Sep 15);

(a) Personnel must be deployed in conjunction with Operation Enduring Freedom supporting military operations in Afghanistan.

(3) Djibouti (as of 01 Jul 02); July 1, 2002)

(4) Yemen (as of 10 Apr 02);

(5) Somalia and Syria (as of 01 Jan 04);

3. Kosovo Area, Executive Order 13119 (24 Mar 99).

a. The Federal Republic of Yugoslavia (Serbia/Montenegro);

b. Albania;

c. Kosovo;

d. The Adriatic Sea; and

e. The Lonian Sea – north of the 39th parallel.

4. Arabian Peninsula Area, Executive Order 12744 (17 Jan 91):

a. The Persian Gulf;

b. The Red Sea;

c. The Gulf of Oman;

d. The part of the Arabian Sea that is north of 10 degrees north latitude and west of 68 degrees east longitude;

e. The Gulf of Aden;

f. The total land areas of Iraq, Kuwait, Saudi Arabia, Oman Bahrain, Qatar, and the United Arab Emirates;

g. Jordan (as of 19 Mar 03); and

a. Lebanon (as of 12 Feb 05).

III. TAX FILING OPTIONS FOR DEPLOYING PERSONNEL

A. Filing Before Deployment.

1. If the member has all of the documents and information necessary to file a complete and accurate return, the member may attempt to file the tax return before deploying.

2. A member who chooses to file a tax return early could miss opportunities to reduce taxable income, for example, through making IRA contributions. Therefore, filing before deployment is not always advisable, and tax program volunteers should make the member aware of possible filing extensions.

B. Filing During Deployment.

1. This is the least preferred option. The member's focus in the deployed area should be on fulfilling the mission.

2. Due to constant personnel turnover in deployed areas, maintaining a tax assistance program is difficult. While occasionally there are tax assistance programs in deployed areas, the member may not have access to all documentation necessary to file a complete and accurate return.

C. Authorizing Someone Else to File the Return.

1. Generally, a joint return must be signed by both spouses. Mailing a tax return to the deployed member for signature incurs delays and has the potential for being lost in transit.

2. Power of Attorney. A spouse may use a special power of attorney to sign and file a joint tax return for their spouse, but only if the non-signing spouse is unable to sign to due disease or injury, or is continuously absent from the United States (including Puerto Rico) for at least 60 days prior to the filing deadline. The special power of attorney must contain specific language authorizing the spouse to sign and file the return. Treas. Reg. § 1.6012-1(a)(5).

3. IRS Form 2848, Power of Attorney. This form is the IRS power of attorney form and can also be used to authorize a spouse to sign and file a tax return on behalf of the military member. Check the box on line 5a "Sign a return," to allow a spouse to sign the return. Line 5a of Form 2848 should also contain the following statement: "This power of attorney is being filed pursuant to Treasury Regulations section 1.6012-1(a)(5), which requires a power of attorney to be attached to a return if the return is signed by an agent by reason of continuous absence from the United States for a period of at least 60 days prior to the date required by law for filing the return."

4. Statement Attached to the Return. If the military member is deployed to a combat zone or qualified hazardous duty area and the spouse does not have a power of attorney or Form 2848, the spouse can still sign for the deployed military member.

    a. The spouse must attach a signed statement to the return that explains that the member is currently serving in a combat zone.

    b. This option is not available if the spouse and deployed member are filing returns as married, filing separately.

5. Member in Missing Status. If the deployed member is in a missing status, the spouse can still file a joint return for any year beginning not more than 2 years after the end of the combat zone activities.

6. Member Incapacitated. If the deployed member is unable to sign the return because of disease or injury but tells the spouse to sign the return, the spouse may sign the return for the member.

    a. The spouse should sign the deployed member's name, followed by the words "by [spouse's name], Husband (or Wife).

    b. The spouse should also include a signed, dated statement showing the form number of the return, the tax year, the reason the member could not sign and that the member agreed to the spouse signing the return for him/her.

7. Member Died During the Year. If the member died during the year, and if the spouse did not remarry before the end of the year, the spouse can file a joint return for the year.

    a. The spouse should write in the signature area "Filing as surviving spouse."

    b. If an executor or administrator has been appointed, both the surviving spouse and the executor or administrator must sign the return.

IV. EXTENSION OF TAX DEADLINES

A. Extension pursuant to I.R.C. § 7508, Time for performing certain acts postponed by reason of service in combat zone or contingency operation.

1. Eligibility. The following individuals are eligible for an extension of tax deadlines under Section 7508:

a. Military members serving in a combat zone or in direct support of a combat zone.

b. Military members serving in a qualified hazardous duty area or in direct support of a qualified hazardous duty area.

c. Military members deployed outside the United States away from the member's permanent duty station while participating in a contingency operation designated by the Secretary of Defense. "Contingency operation is defined by 10 U.S.C. § 101(a)(13).

d. Spouses of a military member described above.

e. Civilians serving in support of the Armed Forces in a combat zone, qualified hazardous duty area, or contingency operation such as the Red Cross, accredited correspondents, and personnel acting under the direction of the Armed Forces in support of those forces.

2. Actions Extended.

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

b. Paying any income, estate, or gift tax (except employment and withholding taxes).

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

d. Filing a claim for credit or refund of any tax.

e. Bringing a suit for any claim for credit or refund.

f. Making a qualified IRA contribution.

g. Allowing a credit or refund of any tax by IRS.

h. Assessment of any tax by the IRS.

i. Giving or making any notice or demand by the IRS for the payment of any tax or for any liability for any tax.

j. Collection by the IRS of any tax due.

k. Bringing suit by the United States for any tax due.

3. Length of Extension. The deadlines for the tax actions described above is extended for the following period:

a. 180 days after the later of:

(1) The last day the member is in the combat zone, qualified hazardous duty area or in direct support of the combat zone or qualified hazardous duty area (or the last day the area qualifies as such); or

(2) The last day of any continuous qualified hospitalization for wounds, disease, or injury sustained from service in the combat zone, qualified hazardous duty area, or in direct support of a combat zone or qualified hazardous duty area (qualified hospitalization is hospitalization that resulted from an injury received while serving in the combat zone).

b. Plus the number of days remaining for the member to take action with the IRS when he or she entered the combat zone or qualified hazardous duty area (or in direct support of the combat zone or qualified hazardous duty area).

Example 1: Captain Margaret Jones entered Saudi Arabia on December 1, 20X1. She remained there through March 31, 20X3, when she departed for the United States. She was not injured and did not return to the combat zone. The deadlines for filing Captain Jones' 20X1, 20X2, and 20X3 returns are figured as follows:

The 20X1 tax return. Assume that the January 20X1 return is due on April 18, 20X2. The deadline is January 14, 20X4. This deadline is 289 days (180 plus 109) after Captain Jones' last day in the combat zone (March 31, 20X3). The 109 additional days are the number of days in the 3½ month filing period (January 1 – April 18, 20X2) that were left when she entered the combat zone.

The 20X2 tax return. Assume that the January 20X2 return is due on April 17, 20X3. The deadline is January 13, 20X4. The deadline is 288 days (180 plus 108) after Captain Jones' last day in the combat zone (March 31, 20X3). The 108 additional days are the number of days in the 3½ month filing period (January 1 – April 18, 20X3) that were left when she entered the combat zone.

The 20X3 tax return. The deadline is not extended because the 180-day extension period after March 31, 20X3, plus the number of days left in the filing period when she entered the combat zone (107) ends on January 12, 20X4, which is before the due date for her 20X3 tax return (April 15, 20X4).

Example 2: A member in the combat zone from 1 October 20X1 to 15 January 20X2 will have 287 days from the date he or she leaves the area to file the 20X1 return. Assume 107 days pass from 1 January until the filing deadline. The extension equals the 180-day extension, plus 107 days of the tax filing season because he or she was in a combat zone or qualified hazardous duty area on 1 January. **Note -** If a member is serving in a combat zone or qualified hazardous duty area, or in direct support of operations in a combat zone or qualified hazardous duty area, on **1 January**, he or she receives the **full 107 days** of the filing period as part of the deadline extension **even if** the return to home station occurs before 17 April.

Example 3: A member entering a combat zone on 1 February 20X1 and serving until 1 May 20X1 will have 256 days from the date he leaves the combat zone to file the 20X1 return. Assume 76 days pass from 1 February until the filing deadline. This period of time is equivalent to the full 180-day extension, plus the 76 days remaining in the filing season when he or she entered the combat zone or qualified hazardous duty area.

4. Necessary Actions.

a. The extension applies automatically. Neither deployed members nor spouses need to file an extension with the IRS to take advantage of the filing extension granted as a result of qualifying combat zone or qualified hazardous duty service.

b. A member, spouse, or affected civilian may notify the IRS that the individual is deployed to a combat zone, qualified hazardous duty area, or in direct support of a combat zone or qualified hazardous duty area by sending an email to combatzone@irs.gov. The email should provide the IRS with the member's name, stateside address, date of birth, and date of deployment. Social security numbers should NOT be emailed. Prior notification suspends the IRS's ability to assess or collect tax. I.R.C. § 7508(e)(2).

c. Civilian taxpayers eligible for the Section 7508 extension should put the words "COMBAT ZONE" and their deployment date in red ink at the top of their tax returns. Service members do not need to do this because the DoD provides advance notice to the IRS.

d. If a taxpayer eligible for the Section 7508 extension receives correspondence from the IRS regarding a collection or examination matter, they may return the notice to the IRS with the words "COMBAT ZONE" and the deployment date in red at the top of the notice and also write "COMBAT ZONE" on the outside of the envelope. Upon receipt of the returned correspondence, the IRS will suspend the action.

B. Extension pursuant to I.R.C. § 6081, Extension of time for filing returns:

1. Automatic two-month extension for certain overseas taxpayers.

a. Eligibility. Treas. Reg. § 1.6081-5(a)(5)-(6), promulgated pursuant to the grant of authority in I.R.C. § 6081(a), establishes an automatic extension until 15 June to file income tax returns for:

(1) "United States citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States and Puerto Rico." Treas. Reg. § 1.6081-5(a)(5).

Note: The term "tax home" has the same meaning as it has for purposes of 26 U.S.C. § 162(a)(2), relating to the deductibility of business travel expenses away from home. This definition is different than domicile, and more closely aligns with a taxpayer's current residence. Accordingly, a military dependent accompanying the sponsor overseas on PCS orders will typically satisfy this requirement.

(2) "United States citizens and residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico." Treas. Reg. § 1.6081-5(a)(6).

(3) In order to qualify for the extension, the taxpayer must be overseas on the regular deadline for timely filing (e.g. 15 April).

b. Application. To claim the extension, the taxpayer must submit a statement with their tax return filed prior to 15 June. If the taxpayer is requesting an additional four-month extension (see para. 2, below), the automatic two-month extension is documented by checking box 8 on IRS Form 4868, and by filing Form 4868 prior to 15 June.

c. Effect. Treas. Reg. § 1.6081-5 extends the time for filing the return and paying the tax. Accordingly, if properly claimed no penalties will be incurred so long as the return is filed on or before 15 June. Statutory interest under 26 U.S.C. § 6601 will, however, accrue during the extension period.

2. Automatic six-month extension for any taxpayer (whether located in the U.S. or overseas), pursuant to Treas. Reg. § 1.6081-4.

   a. Application.

      (1) Complete IRS Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income tax Return. The form requires the taxpayer to calculate the estimate tax (if any) that is owed.

      (2) File the form prior to the date for timely filing (e.g. 15 April) (or 15 June, if the 1.6081-5 automatic two-month extension also applies).

   b. Effect. Treas. Reg. § 1.6081-4 extends the time for filing the return, but not paying the tax. Accordingly, if tax is owed, even if the extension is timely filed, interest will accrue, and the I.R.C. § 6651(a)(2) failure to pay penalty will be imposed. In order to avoid penalties and interest, the estimated tax owed should be paid at the time Form 4868 is filed.

3. Discretionary extension through 15 December for overseas taxpayers.

   a. Application. The taxpayer must send the IRS a letter, prior to the extended due date (e.g. 15 October) explaining why an additional two-month extension is needed. See Pub. 54 for the current mailing address. No response will be received, unless the request is denied.

   b. Effect. Similar to the automatic extension obtained by filing Form 4868, this extends the time to file the return, but not the time to pay the tax. Accordingly, if tax is owed, interest will accrue and the I.R.C. § 6651(a)(2) failure to pay penalty will be imposed.

V. INCOME TAX EXCLUSION

A. Eligibility.

1. The following military members are eligible for the income tax exclusion:

   a. Military members deployed to the combat zone or in direct support of a combat zone.

   b. Military members deployed to a qualified hazardous duty area.

   c. Military members in direct support of a qualified hazardous duty area who are receiving hostile fire pay/imminent danger pay that is directly related to the dangers of supporting the qualified hazardous duty area.

2. The following are NOT eligible for the income tax exclusion:

   a. Civilians serving in a combat zone, qualified hazardous duty area, or in direct support of a combat zone or hazardous duty area. Civilians, as explained above, are only eligible for the deadline extensions, not the tax exclusion.

   b. Spouses of military members.

3. Qualifying service by a military member for one day qualifies the member for the tax exclusion for the entire month.

4. Hospitalization of a military member outside the combat zone or qualified hazardous duty area for part of a month as a result of wounds, disease, or injury sustained while serving in the combat zone or qualified hazardous duty area qualifies the member for the tax exclusion for the entire month.

B. Excluded Income. The following income can be excluded from gross income for income tax purposes. Note: basic pay remains subject to Social Security and Medicare tax.

1. Active duty pay earned in any month the member served in a CZ or QHDA. Enlisted personnel and warrant officers who serve in a CZ or QHDA during any part of a month can exclude all of their basic pay for that month from income. The amount of the exclusion for commissioned officers is limited to the highest rate of enlisted pay. .

2. Imminent danger or hostile fire pay.

3. A dislocation allowance if the move begins or ends in a month the member served in a CZ or QHDA.

4. A reenlistment bonus if the voluntary extension or reenlistment occurs in a month the member served in a CZ or QHDA.

5. Pay for accrued leave earned in any month the member served in a CZ or QHDA.

6. Continuation pay only if the agreement to perform additional years of service is signed by the member in a month when he or she is serving in a CZ or QHDA.

7. Continuation pay under the Blended Retirement System only if: (1) the Service Member becomes entitled to BRS continuation pay while serving in a combat zone; and (2) the agreement to perform additional years of service is signed by the member while serving in a CZ or QHDA.

8. Pay received for duties as a member of the armed forces in clubs, messes, post and station theaters, and other nonappropriated fund activities. The pay must be earned in a month the member served in a CZ or QHDA.

9. Awards for suggestions, inventions, or scientific achievements members are entitled to because of a submission they made in a month they served in a combat zone.

10. Student loan repayments made as part of the DoD Loan Repayment Program. Generally, these payments are compensation for services. They are excluded from income during the month(s) the member provides qualifying CZ and QHDA service.

11. The Redux Payment of $30,000. This payment is considered a career service bonus (a type of special pay) available to certain members who execute a written agreement to remain on active duty until completion of 20 years of service and accept a reduced percentage in calculating pay on retirement. Generally, it is taxable income. However, it is excluded from income if the member executes the agreement to receive the payment while providing qualifying CZ or QHDA service.

C. Income Not Excluded.

1. Military pension or retired pay

2. Separation payments.

VI. CONCLUSION

APPENDIX

FEDERAL TAX PRACTICE

TABLE OF CONTENTS

CAUTION: This document is meant only as an educational outline for training purposes and as a starting point for conducting tax research. Many of the IRS publications and forms were not finalized at the time of the drafting of this document. In addition, potential tax law changes are continuously under debate. Tax practitioners are highly encouraged to check the IRS website www.irs.gov for the latest publications and guidance.

I. REFERENCES.

A. Title 26, United States Code (Internal Revenue Code (I.R.C.)).

B. Title 26, Code of Federal Regulations, Parts 1 and 301 (Treasury Regulations (Treas. Reg.)).

C. Internal Revenue Manual, https://www.irs.gov/irm.

D. Understanding IRS Guidance – A Brief Primer, Internal Revenue Service, https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer.

E. Tax Code, Regulations and Official Guidance, Internal Revenue Service, https://www.irs.gov./privacy-disclosure/tax-code-regulations-and-official-guidance.

F. IRS Pub. 4012, VITA/TCE Volunteer Resource Guide.

G. IRS Pub. 4961, VITA/TCE Volunteer Standards of Conduct, and IRS Form 13615, Volunteer Standards of Conduct Agreement – VITA/TCE Programs.

H. AR 27-3, The Army Legal Assistance Program (26 March 2020).

I. IRS Pub. 947, Practice Before the IRS and Power of Attorney (Rev. Feb. 2018).

J. IRS Form 2848, Power of Attorney and Declaration of Representative (Rev. Jan. 2018) and Instructions.

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

II. INTERNAL REVENUE SERVICE

A. The Internal Revenue Service (IRS) is a Bureau of the Department of the Treasury.

1. The Commissioner of the Internal Revenue is appointed for a five-year term by the President with the advice and consent of the Senate. I.R.C. § 7803(a)(1)(A)-(B).

2. The Commissioner has such powers as the Secretary of the Treasury shall prescribe, including (*i*) to administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party; and (*ii*) to recommend to the President a candidate for the Chief Counsel of the Internal Revenue Service. I.R.C. § 7803(a)(2)(A)-(B).

3. Chief Counsel for the Internal Revenue Service. Chief law officer for IRS. Appointed by the President with the advice and consent of the Senate. I.R.C. § 7803(b)(1)-(3).

   a. Reports directly to the Commissioner, except for a joint reporting obligation to the General Counsel for the Department of the Treasury for matters of tax litigation and advice or interpretation of tax law not solely relating to tax policy.

   b. Reports directly to the General Counsel of the Department of the Treasury for advice or interpretation of tax law relating solely to tax policy.

4. National Taxpayer Advocate and Office of the Taxpayer Advocate.

   a. Senior Executive Service official who reports to the Commissioner.

   b. Charged with assisting taxpayers in resolving IRS problems, identifying areas in which those problems arise, proposing changes in administrative practices, and identifying potential legislative changes. I.R.C. § 7803(c)(1)-(2).

c. The National Taxpayer Advocate issues detailed reports to Congressional committees consistent with the office's mission and addressing specific matters. I.R.C. § 7803(c)(2)(B).

5. Chief of Appeals and Internal Revenue Service Independent Office of Appeals. I.R.C. § 7803(e)(1)-(2).

a. Senior Executive Service official reporting directly to the Commissioner.

b. Charged with resolving federal tax controversies without litigation on a basis that is fair to both government and taxpayer; promotes consistent application and interpretation of federal tax law, as well as voluntary compliance; and enhances public confidence in the integrity and efficiency of IRS. I.R.C. § 7803(e)(3).

c. The Office of Appeals shall have authority to obtain assistance and advice from the Office of Chief Counsel, but the latter shall ensure to the extent practicable that assistance and advice is not provided by staff who were previously involved with the case. I.R.C. § 7803(e)(6)(B).

6. Other statutory IRS officials include the Treasury Inspector General for Tax Administration and the IRS Chief Information Officer. I.R.C. § 7803(d), (f).

B. IRS Organization: four major operating divisions and numerous principal offices.

1. Operating divisions:

a. Wage and Investment.

b. Large Business and International.

c. Small Business/Self Employed.

d. Tax-Exempt and Governmental Entities.

2. Principal offices include:

a. Office of Chief Counsel.

b. Appeals.

c. Office of Professional Responsibility (OPR).

d. Taxpayer Advocate Service.

e. Criminal Investigation.

f. Return Preparer Office.

III. SOURCES OF TAX LAW

A. United States Constitution.

1. Sixteenth Amendment: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

2. The Sixteenth Amendment overruled *Pollock v. Farmers' Loan & Trust Company*, 157 U.S. 429 (1895), which had invalidated the federal income tax because it failed to satisfy constitutional apportionment requirements. U.S. Const., Art. I, § 9, cl. 4. *Nat'l Fed'n of Indep. Bus. v. Sibelius*, 567 U.S. 519, 571 (2012); *see also Eisner v. Macomber*, 252 U.S. 189, 205-06 (1920) (same).

B. Federal statutes.

1. Internal Revenue Code (I.R.C.), codified into positive law at Title 26, United States Code.

a. Example citation: I.R.C. § 163.

2. Practice Note. The Internal Revenue Code contains permanent provisions of tax law, but also numerous "tax extender" provisions, which expire periodically. Frequently, tax extenders are passed late in the year and may contain retroactive benefits. Common tax extender provisions include the tuition and fees deduction and the itemized deduction for mortgage insurance premiums. *See, e.g.,* I.R.C. §§ 163(h)(3)(E), 222. For an example of a Congressional reauthorization of various tax extender provisions, see the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Pub. L. No. 116-94, Div. Q, §§ 101-146 (Dec. 20, 2019).

C. Tax treaties. These are typically reciprocal international agreements where both countries agree to favorable tax provisions for citizens of the other country who are subject to each other's tax laws.

D. Treasury Regulations.

1. Title 26, Code of Federal Regulations (C.F.R.).

a. Example citations: Treas. Reg. § 1.72-16(a), Temp. Treas. Reg. § 1.338-4T.

b. The Code of Federal Regulations is maintained by National Archives and Records Administration, Office of the Federal Register.

2. Temporary or permanent regulations issued by Department of Treasury and Internal Revenue Service.

a. Notice of Proposed Rulemaking (published in the Federal Register).

b. Public comment.

c. Promulgation via Treasury Decision (T.D.).

(1) Example citation: T.D. 9792, 2016-48 I.R.B. 751. (See below for I.R.B.)

3. May be legislative, procedural, or interpretive.

a. Legislative regulations are promulgated by specific grant of statutory authority and are tantamount to Congressional enactment.

b. Procedural regulations are promulgated by general authority and are binding upon the IRS.

c. Interpretive regulations are promulgated by general authority and are entitled to agency deference.

E. Federal trial courts.

1. Tax cases are litigated at the trial level in three different federal courts:

a. United States District Court.

(1) Taxpayer pays tax and sues for refund.

(2) Jury trial available.

b. Court of Federal Claims.

(1) Taxpayer pays tax and sues for refund.

(2) Article I legislative court with no jury trial available.

c. Tax Court.

(1) Article I legislative court with no jury trial available.

(2) Procedure and burden of proof:

(a) After the IRS issues a notice of deficiency to the taxpayer, the taxpayer petitions the Tax Court to initiate a proceeding. I.R.C. §§ 6212-6213.

(b) Unlike in other forums, the notice of deficiency is presumed correct. *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

(c) However, the taxpayer may shift the burden of proof to the IRS by introducing "credible evidence" regarding the matter in dispute and having complied with relevant substantiation and recordkeeping requirements. I.R.C. § 7491(a)(1)-(2).

(i) Credible evidence. That which the court would consider after critical analysis sufficient to decide an issue if no contrary evidence were submitted. *Higbee v. Comm'r*, 116 T.C. 438, 442, 443-446 (2001) (concluding that self-serving testimony and inconclusive documentation did not constitute credible evidence).

(ii) Federal tax law generally requires taxpayers to maintain records "sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown" on their returns. I.R.C. § 6001; Treas. Reg. § 1.6001-1(a).

(iii) Moreover, various Code sections impose stricter requirements as a prerequisite for certain deductions. *See, e.g.*, I.R.C. §§ 170A (charitable contributions), 274 (travel, entertainment, and similar), 280F (depreciation for property with potential for substantial personal use).

(3) The four types of opinions arising from Tax Court cases are summarized below [see Guidance for Petitioners: After

Trial, https://www.ustaxcourt.gov/petitioners_after.html #AFTER2]:

(a) Tax Court Opinion. This is the most persuasive authority and issued where there is a "sufficiently important legal issue or principle." These are also called Division Opinions.

(i) Example citation: *Martin v. Comm'r*, 96 T.C. 814 (1991).

(b) Memorandum Opinion. The Tax Court issues a Memorandum Opinion in cases where there are no novel legal issues and where the law is settled or the dispute is factually driven. The Court views a Memorandum Opinion as non-binding precedent. *Dunaway v. Comm'r*, 124 T.C. 80, 87 (2005) ("None of these Memorandum Opinions … elaborates at any length on its rationale, and Memorandum Opinions of this Court are not regarded as binding precedent."). Although not binding, litigants and judges may cite them as authority in Tax Court and frequently do so.

(i) Example citations: *Striker v. Comm'r*, T.C. Memo. 2015-248; *Gillis v. Comm'r*, T.C. Memo. 1986-576, 52 T.C.M. (CCH) 1128.

(ii) Note: Pagination for Memorandum Opinions is not available before 1995. Therefore, throughout this Deskbook, decisions before 1995 contain parallel citations to the unofficial T.C.M. (CCH) reporter. For Memorandum Opinions on or after 1 August 2012, the opinions are paginated and posted on the Tax Court website. A pinpoint citation for a post-1 August 2012 case is as follows: *Striker v. Comm'r*, T.C. Memo. 2015-248, at *11. To retrieve page citations for cases from 1995 and July 31, 2012, page numbers are available from the Tax Court website, which

retains the pagination of the original slip opinions. For pre-1995 cases, an example pinpoint citation is the following: *Gillis v. Comm'r*, T.C. Memo. 1986-576, 52 T.C.M. (CCH) 1128, 1130. For more information, see I.R.S. Chief Counsel Notice 2012-015 (Aug. 1, 2012), https://www.irs.gov/pub/irs-ccdm/cc-2012-015.pdf.

(c) Summary Opinion. A Summary Opinion is issued where the amount in dispute is $50,000 or less and the taxpayer elects to have his or her case deemed a small tax case. A taxpayer may not appeal a small tax case decision. I.R.C. § 7463(a). Moreover, the decision "shall not be treated as precedent for any other case." Section 7463(b).

(i) Example citation: *Keeter v.* Comm'r, T.C. Summ. Op. 2017-36.

(d) Bench Opinion. This is an opinion delivered by a Tax Court judge orally in court during a trial session. Bench Opinions after 1 March 2008 are accessible on the Tax Court's website, but they "shall not be relied upon as precedent, except as may be relevant for purposes of establishing the law of the case, res judicata, collateral estoppel, or other similar doctrine." Tax Court Rule 152(c).

F. Appellate review.

1. Circuit Courts of Appeal rule on appeals from District Court and Tax Court decisions.

a. Under the *Golsen* rule, the Tax Court applies the law of the circuit to which the taxpayer's appeal would lie. *Golsen v. Comm'r*, 54 T.C. 742 (1970).

(1) Therefore, the same tribunal may apply different law to different taxpayers, depending where the appeal lies.

2. Court of Federal Claims cases are appealed to the Court of Appeals for the Federal Circuit.

3. The Supreme Court is the final appellate court for all federal tax cases.

G. Official IRS Guidance.

1. Revenue Rulings: IRS applies the tax law to a given set of facts.

a. Example citation: Rev. Rul. 2015-23, 2015-52 I.R.B. 751.

2. Revenue Procedure: IRS's official statements of procedure it will apply to specified circumstances.

a. Example citation: Rev. Proc. 2014-45, 2014-341 I.R.B. 388.

b. Practice note. Many tax law provisions contain amounts that are adjusted annually for inflation. The IRS issues Revenue Procedures and other notices publishing the updated amounts. These inflation-adjusted amounts are then incorporated into Pubs. 17 and 4012 and other forms and guidance. *See, e.g.,* Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

3. Action on Decision: IRS Chief Counsel's formal memorandum announcing the Service's litigation position with respect to a court decision.

a. Acquiescence: Where the IRS announces it will not advance a position in other courts after an unfavorable ruling; e.g., if the Service's position is rejected by one federal circuit, the Service may notify the public that it will not advance its former position in other circuits.

H. Where to find tax law?

1. United States Code (Title 26): Office of Law Revision Counsel, https://uscode.house.gov.

2. Tax treaties: IRS's Tax Treaties website, https://www.irs.gov/individuals/international-taxpayers/tax-treaties, and the Department of Treasury's Resource Center for International Tax, https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/default.aspx.

3. Treasury Regulations (Title 26, Code of Federal Regulations), https://ecfr.gov. See also the Code of Federal Regulations (Annual Edition), https://www.govinfo.gov/app/collection/cfr.

4. Internal Revenue Bulletin (I.R.B.), https://www.irs.gov/irb. The IRS's weekly, authoritative publication for announcing official rulings and procedures of the IRS, including Revenue Rulings and Revenue Procedures, as well as Treasury Decisions, Tax Conventions, and other relevant materials.

   a. Until 2008, the IRS also published a semi-annual Cumulative Bulletin (C.B.). Cumulative Bulletins are available by searching https://govinfo.gov.

I. Unofficial IRS Guidance.

1. Private Letter Ruling: written statement to a taxpayer based on facts provided by the taxpayer.

   a. The taxpayer seeks a determination of tax consequences before consummating a transaction or filing a return.

   b. Binding on the IRS if the taxpayer fully and accurately describes the facts.

   c. Non-precedential for other taxpayers, but the letters are typically made public after appropriate redaction.

2. Technical Advice Memorandum.

   a. Office of Chief Counsel guidance issued upon the request of an IRS director or Appeals area director in response to a technical or procedural question during a proceeding.

b. Constitutes a final determination as to the specific issue in the proceeding.

3. Other informal guidance: Notices, Announcements, General Counsel Memoranda, Office of Chief Counsel Memoranda (see IRS website).

4. IRS Publications.

a. User-friendly statements by the IRS on tax law issues.

b. IRS publications contain few legal citations and do not constitute an official source of tax law. However, for preparation of tax forms and maintaining general compliance with federal tax laws, they are the most frequently used resource.

c. Throughout this Deskbook, annual IRS Publications are generally cited as "Pub. *XXX*," where XXX represents the publication number. The year and/or date of publication is generally omitted. Headings and subheadings are indicated by parentheses and separated by dashes, e.g., "Pub. *XXX* (*Heading – Subheading*)."

d. Comprehensive publications that address a wide variety of individual tax issues are Pub. 17, Your Federal Income Tax, and Pub. 4012, VITA/TCE Volunteer Resource Guide.

J. Joint Committee on Taxation (JCT).

1. Consists of five members each from the Committee on Ways and Means from the House of Representatives and the Committee on Finance for the Senate.

2. Charged with investigating the administration of taxes by the IRS and measures or methods for simplification. I.R.C. § 8022(1)-(2).

3. Reports results of its investigations and recommendations. I.R.C. § 8022(3).

4. The JCT's publishes a "Bluebook" containing a general explanation of enacted federal tax legislation. Although the Bluebook does not constitute official legislative history, the reports are often studied by practitioners where ambiguities arise in the law.

IV. MILITARY TAX PRACTICE

A. Volunteer Income Tax Assistance (VITA) program.

1. IRS-sponsored program to provide tax return preparation services for certain underserved persons through various partner organizations.

2. As noted below, organizations participating in the VITA program must adhere to IRS requirements, including certain standards of conduct.

a. The VITA program has specific requirements governing the complexity of returns that qualify under the program. See Pub. 4012, "Scope of Service."

3. Congress formally codified the Community VITA program on July 1, 2019 as part of the Taxpayer First Act of 2019, Pub. L. No. 116-25 (adding I.R.C. § 7526A).

a. Since 2008, certain organizations sponsoring VITA programs previously received matching grants from the IRS with Congressional authorization. *See, e.g.,* Consolidated Appropriations Act, 2008, Pub. L. No. 110-161, 121 Stat. 1844, 1976 (2007).

b. Note that Section 7526A states that the definition of "underserved population" includes "members of the Armed Forces and their spouses." I.R.C. § 7526A(e)(4).

B. Army Regulation 27-3, Legal Assistance.

a. The Army requires Legal Assistance offices to provide certain tax assistance. Para. 3–*5h*(1): "*Required Assistance*. Legal assistance

will be provided on real, personal property tax, and federal income tax issues."

(1) Tax assistance relating to other types of taxes, such as estate, inheritance, income (non-federal), and gift taxes, is optional, as is appealing tax rulings and other findings. Para. 3–*5h*(1)

b. The establishment of VITA tax centers, while not mandatory, is "strongly encouraged."

(1) See para. 3–*5h*(1): "*Optional Assistance.* … Based on the availability of resources, income tax returns may be prepared and electronically filed in cooperation with the [VITA] program. While an optional service, establishing VITA tax centers for the preparation of federal and state income tax returns provides an important service to clients and is strongly encouraged. Federal and state tax codes and related statutes contain many specialized and highly nuanced provisions specific to military service. As a result, Army legal assistance offices and tax centers are generally in the best position to provide the most accurate and comprehensive legal advice and tax return preparation services to the military community. The tax program directly facilitates combat readiness and Soldier and family resilience by providing a high-quality, free service that reduces the potential for future legal problems by facilitating timely compliance with applicable tax laws."

(2) See also para. 4–4*a*: "Income tax assistance is an important aspect of a commander's legal assistance program. Tax assistance directly enhances readiness for mobilization or deployment. Solders who meet their federal and state tax obligations are able to focus on their wartime mission without fear of audit or collection actions."

c. The Army Legal Assistance mission generally does not extend to private business activities that would fall outside the scope of the IRS's VITA program.

(1) Para 3–5*h*(3): "Tax assistance on substantial private business activities (for example, multiple rental properties that the client has not occupied as their principal residence) is outside the scope of the legal assistance program[.] … For purposes of this limitation, substantial private business activities are those that do not meet the IRS's VITA program requirements for the preparation of" IRS Form 1040, Schedule C or C-EZ."

(2) *Exception*. Family child care (FCC) providers eligible for legal assistance are not disqualified from receiving legal assistance on income tax matters, even if these activities would not qualify under the VITA program. Para. 3–6*a*(3).

d. Where legal assistance centers establish VITA tax programs, compliance with IRS VITA program requirements is mandatory. Para. 4–4*c*.

e. Chiefs of Legal Assistance may authorize, "[s]ubject to availability of adequate resources and expertise," additional tax assistance that exceeds the scope of the VITA program, as long as the assistance is otherwise consistent with AR 27-3. Para. 4–4*c*.

(1) For example, noncash charitable contributions over $500 are out-of-scope for the VITA program, but are within the permissible scope of services that a Chief of Legal Assistance may authorize under para 4–4*c*.

(2) However, Chief of Legal Assistance may not authorize tax assistance for non-FCC private business activities because such activities do not qualify for legal assistance under AR 27-3.

C. Standards of conduct.

1. For licensed attorneys, rules of professional responsibility apply, regardless of whether tax preparation constitutes a legal service. AR 27-26, para. 7*a*.

2. The VITA program requires adherence to specified standards of conduct, including:

a. Not accepting payment, soliciting donations, or accepting refund payments from customers;

b. Not soliciting business from taxpayers using their financial or other information;

c. Not knowingly preparing false returns; and

d. Not engaging in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct deemed to have a negative effect on the VITA programs. See Pub. 4961; Form 13615.

3. Failure to adhere to VITA standards can result in expulsion from the VITA program, deactivation of the VITA site's electronic filing identification number, termination of grant funds to the VITA site, and other consequences. IRS Pub. 4961; IRS Form 13615.

D. An individual preparing tax returns under the VITA program is not a "tax return preparer" for purposes of the penalty regime under I.R.C. §§ 6694 and 6695 for paid preparers. I.R.C. § 7701(a)(36); Treas. Reg. § 301.7701-15(a) (defining "tax return preparer" as one who prepares a return for compensation). See below for rules relating to practice before the IRS, which, like these penalties, also apply only to paid preparers.

V. THE TAX PREPARER AND THE IRS

A. Practice before the Internal Revenue Service.

1. The Department of the Treasury has statutory authority to regulate those who practice before the agency. 31 U.S.C. § 330. The D.C. Circuit ruled that this authority does not extend to paid preparers who submit forms to the IRS, but do not engage in representational acts on behalf of a client. *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014).

2. The Department of Treasury Circular 230, 31 C.F.R. Part 10 (June 12, 2014) [hereafter cited as "Circular 230," § __], governs the conduct of professionals who practice before the IRS.

   a. Circular 230 applies only to paid preparers. Circular 230, § 10.2(a)(8); I.R.C. § 7701(a)(36); Treas. Reg. § 301.7701-15.

   b. **Therefore, Circular 230 does not apply to the VITA program**.

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

   a. Attorneys, Certified Public Accountants, and Enrolled Agents have broad authority to practice. Circular 230, § 10.3(a)-(c).

   b. Other individuals with limited authority include enrolled actuaries, enrolled retirement plan agents, registered tax return preparers, full-time employees, general partners, and administrators or personal representatives. Circular 230, § 10.3(d)-(f).

4. Practitioners must exercise due diligence:

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

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

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

5. Practitioners must not unreasonably delay the prompt disposition of any matter before the IRS. Circular 230, § 10.23.

6. Practitioners who know that the client has not complied with federal tax laws or has made an error or omission must advise the client promptly of such noncompliance, error, or omission and the associated consequences. Circular 230, § 10.21.

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

   a. Practitioners may not willfully, recklessly, or through gross incompetence sign a return that the practitioner knows or reasonably should know contains a position that:

      (1) Lacks a reasonable basis;

      (2) Is an unreasonable position under I.R.C. § 6694(a)(2); or

      (3) Is a willful attempt by the practitioner to understate tax liability or a reckless or intentional disregard of rules or regulations by the practitioner under I.R.C. § 6694(b)(2). Circular 230, § 10.34(a).

   b. Practitioners may rely in good faith without verification upon information furnished by the client. However, the practitioner may not ignore the implications of information furnished to or known by the practitioner. The practitioner must make reasonable inquiries if the information appears incorrect, inconsistent with an important fact or assumption, or incomplete. Circular 230, § 10.34(d).

   c. When giving written advice, practitioners must:

      (1) Base the advice on reasonable factual and legal assumptions, including assumptions as to future events;

      (2) Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;

(3) Use reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter;

(4) Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable;

(5) Relate applicable law and authorities to facts; and

(6) Not, in evaluating a federal tax matter, consider the possibility that a tax return will not be audited or that an issue will not be raised on audit. Circular 230, § 10.37(a)(2).

8. Practitioners who are shown to be incompetent or disreputable; fail to comply with the provisions of Circular 230; or with intent to defraud, willfully and knowingly mislead or threaten a client or prospective client may be censured, suspended, or disbarred from practice before the IRS. Circular 230, § 10.50(a).

B. Client representation issues.

1. A power of attorney is typically required to represent a taxpayer at a meeting before the IRS or to make written submissions for the taxpayer in response to an IRS inquiry.

2. Form 2848, Power of Attorney and Declaration of Representative. Form 2848 must be obtained from the client to represent him or her before the IRS or to receive confidential tax information pertaining to the client, as well as to perform various other acts. See Pub. 947; Form 2848 Instructions.

3. An individual holding power of attorney generally may not sign a return for the taxpayer, except in limited circumstances such as disease or injury or absence from the United States for 60 days or more before the return deadline. Treas. Reg. § 1.6012-1(a)(5).

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

a. Under I.R.C. § 7525, the protection of confidentiality that applies to attorney-client communications also applies to communications between a taxpayer and a federally authorized tax practitioner. The provision is limited to the scope of the attorney-client privilege. *See, e.g., United States v. Frederick*, 182 F.3d 496, 502 (1999).

(1) There is no common law accountant-client privilege. *Couch v. United States*, 409 U.S. 322, 335 (1973).

b. Information transmitted to an attorney to prepare a tax return is not intended to be confidential, but rather is intended for disclosure to the IRS. Therefore, such communications are not privileged. *See, e.g., United States v. BDO Seidman*, 337 F.3d 802, 812-13 (7th Cir. 2003); *United States v. Lawless*, 709 F.2d 485, 488 (7th Cir. 1983).

C. Penalties under the Internal Revenue Code. *See* I.R.M., Part 20.

1. Terminology.

a. Reasonable basis. A position has a reasonable basis if it is reasonably based on one or more of the authorities described in Treas. Reg. § 1.6662-4(d)(3)(iii), when considering the relevance and persuasiveness of the authorities, as well as subsequent developments. Merely arguable or colorable claims do not satisfy this standard. Treas. Reg. § 1.6662-3(b)(3).

b. Substantial Authority. A position has substantial authority where the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting a contrary treatment, considering the relevance and persuasiveness of the authorities. The substantial authority standard is more stringent than the reasonable basis standard, but less stringent than the "more likely than not" standard. Treas. Reg. § 1.6662-4(d)(2), (d)(3)(i)-(ii).

c. More likely than not. The more-likely-than-not standard means the practitioner reasonably believes, based on analysis of pertinent facts and the authorities stated in Treas. Reg. § 1.6662-4(d)(3)(iii), that there is a greater-than-50% likelihood of success on the merits if the position were challenged. Treas. Reg. § 1.6694-2(b)(1). (This standard applies to tax shelters and "reportable transactions" and is not further addressed herein. I.R.C. § 6662A.)

d. Practitioners often regard the above standards as equivalent to a likelihood of success on the merits as follows: reasonable basis (20%), substantial authority (40%), and more-likely-than-not (>50%). Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring And Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999 (see Table 7).

e. Irrelevant factors. The possibility that a return will not be audited or, if audited, that an item will not be addressed, is not relevant in determining whether the above standards are met. Treas. Reg. §§ 1.6662-4(d)(2), 1.6694-2(b)(1).

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

(1) The following constitute authority considered in meeting the reasonable basis, substantial authority, and more-likely-than-not standards: (*i*) the Internal Revenue Code and other federal statutes; (*ii*) proposed, temporary and final regulations; (*iii*) revenue rulings and revenue procedures; (*iv*) tax treaties; (*v*) court cases; (*vi*) legislative histories; (*vii*) private letter rulings and technical advice memoranda issued after October 31, 1976; (*viii*) actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general and counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); and (*ix*) IRS notices and announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

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

2. Taxpayer Penalties. The following are penalties commonly assessed upon individual taxpayers.

a. Delinquency Penalties. I.R.C. § 6651.

(1) Failure to file a timely return. For each month or fractional month that a return remains unfiled, a penalty of 5% applies, up to a ceiling of 25%. I.R.C. § 6651(a)(1).

(a) If the return is more than 60 days late, a minimum penalty applies. The minimum penalty is the lesser of (1) a statutory amount of $435, as adjusted annually for inflation; or (2) 100% of the tax due. I.R.C. § 6651(a) (flush language), (j).

(2) Failure to pay tax. For every month or fractional month that tax owed remains unpaid, a penalty of 0.5% applies, up to a maximum of 25%. I.R.C. § 6651(a)(2).

(3) The failure to file penalty is reduced by the failure to pay penalty where both apply. Therefore, the maximum penalty under these provisions is 47.5% (5% for five months (4.5% + 0.5%) and 0.5% for the next 45 months).

(4) The taxpayer may defend against imposition of the above penalties by showing that he or she acted with "reasonable cause" and not "willful neglect." In practice, this standard is difficult to meet because tax filing and payment obligations are widely known. *See, e.g., United States v. Boyle*, 469 U.S. 241 (1985) (reliance on attorney who missed filing deadline did not constitute reasonable cause).

b. Accuracy-related penalties. I.R.C. § 6662.

(1) These penalties apply to filed returns where the taxpayer's reported tax due is less than it should have been, including negative amounts resulting from refundable credits. I.R.C. § 6664(a). The IRS may assess an accuracy-related penalty against a taxpayer where he or she (*i*) acts with negligence;

(*ii*) disregards rules or regulations; or (*iii*) substantially underpays his or her tax liability. I.R.C. § 6662(b)(1)-(2).

(2) The maximum accuracy-related penalty is 20%. I.R.C. § 6662(a).

(a) These penalties are not "stacked," i.e., if a taxpayer both shows negligence and substantially underpays income tax, the penalty remains 20%. Treas. Reg. § 1.6662-2(c).

(b) The penalty is assessed only upon the portion of the return that is attributable to conduct covered by Section 6662. I.R.C. § 6662(b); Treas. Reg. § 1.6662-2(b)(1) ("amount is … 20 percent of the *portion of an underpayment* of tax … attributable to misconduct") (emphasis added).

(3) The taxpayer may avoid accuracy-related penalties if he or she shows "reasonable cause" and "good faith" for the portion of the return challenged. The most important factor in this analysis is the "extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Treas. Reg. § 1.6664-4(b)(1). Other important factors include (*i*) the experience, knowledge, and education of the taxpayer; (*ii*) whether the error was isolated; (*iii*) whether the taxpayer consulted a tax professional; and (*iv*) whether the taxpayer received an information return (e.g., a Form W-2 or Form 1099) and had no reason to question its accuracy. Treas. Reg. § 1.6664-4(b)(1).

(4) Negligence. Negligence includes any failure to make a reasonable attempt to comply with the federal tax laws or to exercise ordinary and reasonable care in the preparation of a tax return; this includes failing to keep adequate books and records or to properly substantiate items for the return. Treas. Reg. § 1.6662-3(b)(1).

(a) A return position with a reasonable basis does not result from negligence. Treas. Reg. § 1.6662-3(b)(1).

(b) A taxpayer may not avoid the negligence penalty through disclosure. Treas. Reg. § 1.6662-1 (flush language).

(5) Disregard. Disregard may be careless, reckless, or intentional. Most common is "careless" disregard, i.e., where the taxpayer did not exercise reasonable diligence in taking a return position contrary to a tax rule or regulation. Treas. Reg. § 1.6662-3(b)(2).

(a) The taxpayer may avoid the penalty if he or she has a reasonable basis for the position and adequately discloses it. Treas. Reg. §§ 1.6662-3(c)(1), 1.662-4(f); Form 8275.

(b) The rules and regulations that apply to this penalty include Internal Revenue Code provisions, final or temporary Treasury Regulations, and Revenue Rulings or notices (other than notices of proposed rulemaking) published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2).

(6) Substantial underpayment. A "substantial" understatement is the greater of (*i*) 10% of the amount of tax required to be reported on the return; (*ii*) or $5,000. I.R.C. § 6662(d)(1)(A).

(a) The taxpayer may avoid the penalty if he or she has (*i*) substantial authority for the position; or (*ii*) has a reasonable basis and adequately discloses it. Treas. Reg. §§ 1.6662-4(d)(1), (e)(1), (e)(2)(i), (f)(1); Form 8275.

3. Preparer Penalties. These apply to "tax preparers" as defined under I.R.C. § 7701(a)(36) and Treas. Reg. § 301.7701-15.

a. Understatement of taxpayer liability. I.R.C. § 6694(a).

(1) Tax preparers are subject to penalties where they (*i*) lack substantial authority for a return position and do not

disclose that position; or (*ii*) have no reasonable basis for a return position (regardless of whether disclosed). I.R.C. § 6694(a)(1)(A)-(B).

(2) The penalty amount is the greater of the following: (*i*) $1,000; or (*ii*) 50% of the income derived (or to be derived) from the return. I.R.C. § 6694(a)(1) (flush language).

(3) The tax preparer may avoid the penalty if he or she shows "reasonable cause" and "good faith." Factors to consider in determining reasonable cause include: (*i*) whether the error resulted from a complex or technical provision for which a competent preparer of returns could have made the error; (*ii*) whether the understatement resulted from an isolated error, rather than numerous errors; (*iii*) whether the error was material to the correct tax liability; (*iv*) whether the error would be rare under normal office practices that were actually followed; (*v*) whether the preparer relied on the taxpayer or other advisors; and (*vi*) whether the preparer relied on generally accepted administrative or industry practice. Treas. Reg. § 1.6694-2(e)(1)-(6).

b. Willful, reckless, or intentional conduct. I.R.C. § 6694(b).

(1) Tax preparers are subject to penalties if they (*i*) willfully understate the taxpayer's liability; or (*ii*) recklessly or intentionally disregard rules or regulations.

(2) The amount of the penalty is the greater of the following: $5,000; or (*ii*) 75% of the income derived (or to be derived) from the return.

(3) <u>Willful understatement</u>. A preparer willfully understates the taxpayer's liability where he or she disregards information provided by the taxpayer or others, such as ignoring items of taxable income or overstating the number of dependents the taxpayer claims. Treas. Reg. § 1.6694-3(b).

(4) Reckless or intentional disregard. A preparer recklessly or intentionally disregards a rule or regulation where (*i*) the position taken on a return is contrary to a rule or regulation; and (*ii*) preparer knows of the rule or regulation or was reckless in not knowing of it. Treas. Reg. § 1.6694-3(c)(1).

(a) Rules or regulations include the following: the Internal Revenue Code, final or temporary Treasury Regulations, and Revenue Rulings or notices (other than notices of proposed rulemaking) published in the Internal Revenue Bulletin. Treas. Reg. § 1.6694-3(e).

(b) A preparer is reckless in not knowing of a rule or regulation where the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe. Treas. Reg. § 1.6694-3(c)(1).

(c) A tax preparer does not act recklessly or intentionally where he or she has a reasonable basis for a position and adequately discloses it. If the position is contrary to a regulation, the preparer must make a good-faith challenge to the validity of the regulation and identify the regulation in the required disclosure. Treas. Reg. § 1.6694-3(c)(2).

c. A tax preparer may rely in good faith upon information supplied by the taxpayer or other advisors or preparers based upon reasonable inquiries. The preparer is not required to audit, examine, review, or verify information unless conflicting information is known. Treas. Reg. § 1.6694-1(e)(1). Similarly, a tax preparer may rely upon a previously filed return without verification in the same circumstances. Treas. Reg. § 1.6694-1(e)(2).

4. Preparer penalties for specific matters. I.R.C. § 6695.

   a. A preparer is subject to penalty of $50 for each failure to take certain action, up to a maximum of $25,000, as adjusted for inflation. The penalty applies to the following failures of action: (*i*) to furnish a copy of a return to a taxpayer; (*ii*) to furnish a preparer identification number; (*iii*) to sign a return; (*iv*) to retain a copy of returns or list of taxpayers; and (*v*) to file correct information returns (e.g., Form W-2 or Form 1099). I.R.C. § 6695(a)-(d).

   b. The penalty for negotiation of a taxpayer's check is a statutory amount of $500 per check, as adjusted for inflation. The statutory limit does not apply if the preparer deposits the full amount of the check in his or her bank account for the preparer's own benefit. I.R.C. § 6695(f).

   c. The penalty for a preparer who fails to comply with certain due diligence requirements is a statutory amount of $500 for each failure, as adjusted for inflation. I.R.C. § 6695(g). The due diligence requirements that trigger the penalty are the following tax benefits: (*i*) head of household filing status; (*ii*) the child tax credit; (*iii*) the American Opportunity tax credit; and (*iv*) the earned income tax credit. I.R.C. § 6695(g)(1)-(2).

5. Taxpayers and tax practitioners may be subject to severe civil and criminal penalties for fraudulent or intentional misconduct. Some examples of these penalties are the following:

   a. Civil fraud penalty. I.R.C. § 6663. A penalty of 75% of underpayment amount applies where any portion of the return is attributable to fraud (compare to willful, reckless, or intentional conduct under I.R.C. § 6694(b)).

      (1) The penalty applies to the entire amount of the understatement unless the taxpayer can establish otherwise. I.R.C. § 6663(b).

      (2) Accuracy-related penalties do not apply where the civil fraud penalty is imposed. I.R.C § 6662(b) (flush language).

b. Frivolous return and submissions. I.R.C. § 6702. A penalty of $5,000 applies for frivolous returns and submissions. Frivolous positions (*i*) do not contain information allowing for a determination of the substantial correctness of the taxpayer's liability or contain information that on its face is substantially incorrect; and (*ii*) are based on positions that have been identified under statutory authority as frivolous or reflect a desire to delay or impede the administration of federal tax laws. I.R.C. § 6702(a); I.R.S. Notice 2010-33, 2010-17 I.R.B. 609 (Apr. 26, 2010).

c. Aiding and abetting understatement of tax liability. A penalty of $1,000 per document is imposed upon any person who aids and abets in the preparation or presentation of a document (or portion of a document) used to understate another person's tax liability. I.R.C. § 6701.

d. Criminal penalties. Criminal offenses include tax evasion and willful subscribing materially false tax returns. *See* I.R.C. §§ 7201-7207. These statutes impose terms of imprisonment of up to three or five years per offense and other sanctions.

VI. CONCLUSION