DEPRECIATION

Introduction

Depreciation is the method by which a taxpayer deducts the cost of a capital asset over a period of time. Only assets used in a trade or business or for the production of income are depreciable; assets used for personal purposes are not depreciable. Generally, only assets that “wear out” are depreciable; consequently land or treasured art works cannot be depreciated. When a taxpayer buys a building and the underlying land, the purchase price must be allocated between the two assets according to their relative fair market value. The adjusted basis of the asset is reduced each year by the amount of the depreciation deducted.

Code §168 provides for a depreciation method known as MACRS (modified accelerated cost recovery system) that permits taxpayers to deduct the full cost of depreciable property over a specified “recovery period.” The recovery period is unrelated to the actual useful life of the property. Salvage value, if any, is ignored. Section 168(e) classifies all property into one of several categories; the most common types of property and their recovery periods are:

(a) 3-year: computer software
(b) 5-year: cars, light-duty trucks, and office machines (copiers, and computers)
(c) 7-year: most other tangible personal property, including office furniture and fixtures
(d) 27½-year: residential real property (apartment buildings)
(e) 39-year: nonresidential real property (office buildings and factories)
DEPRECIATION OF PERSONAL PROPERTY

MACRS Computation

Use the following table to calculate the annual depreciation deduction for personal property. All tangible personal property in the course will be either 5-year property (cars, copiers, and computers) or 7-year property (all other tangible personal property, including office furniture and fixtures).

To compute the deduction for the current year, multiply the original basis of the property (after subtracting § 179 first-year expensing, as discussed below) by the applicable percentage rate, using the appropriate column.

<table>
<thead>
<tr>
<th>Recovery year</th>
<th>Applicable percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5-year property</td>
</tr>
<tr>
<td>1</td>
<td>20.0%</td>
</tr>
<tr>
<td>2</td>
<td>32.0%</td>
</tr>
<tr>
<td>3</td>
<td>19.2%</td>
</tr>
<tr>
<td>4</td>
<td>11.5%</td>
</tr>
<tr>
<td>5</td>
<td>11.5%</td>
</tr>
<tr>
<td>6</td>
<td>5.8%</td>
</tr>
<tr>
<td>7</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>100.0%</td>
</tr>
</tbody>
</table>

**Example 1**

Doran purchased $14,000 of furniture for use in her business. Office furniture is 7-year property so her MACRS depreciation deductions are as follows, assuming she keeps the property at least 8 years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Deduction</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$2,002</td>
<td>(14,000 x 14.3)</td>
</tr>
<tr>
<td>2</td>
<td>3,430</td>
<td>(14,000 x 24.5%)</td>
</tr>
<tr>
<td>3</td>
<td>2,450</td>
<td>(14,000 x 17.5%)</td>
</tr>
<tr>
<td>4</td>
<td>1,750</td>
<td>(14,000 x 12.5%)</td>
</tr>
<tr>
<td>5</td>
<td>1,246</td>
<td>(14,000 x 8.9%)</td>
</tr>
<tr>
<td>6</td>
<td>1,246</td>
<td>(14,000 x 8.9%)</td>
</tr>
<tr>
<td>7</td>
<td>1,246</td>
<td>(14,000 x 8.9%)</td>
</tr>
<tr>
<td>8</td>
<td>630</td>
<td>(14,000 x 4.5%)</td>
</tr>
<tr>
<td>Total</td>
<td>$14,000</td>
<td></td>
</tr>
</tbody>
</table>

The deductions are adjustments under § 62(1) because she is using the property in her trade or business. If the property was used for investment purposes or by an employee, the deductions would have been a 2% MIDs. The deductions reduce the basis of the property each year. The adjusted basis of the furniture after year 1 is $11,998 ($14,000 - $2,002). The adjusted basis after year 2 is $8,568 ($11,998 basis after year 1 minus $3,430 deducted in year 2).

Note that although the adjusted basis is declining each year, you should always multiply the original adjusted basis by the appropriate percentage to calculate the depreciation deduction each year.
Prorating Depreciation in the Year of Acquisition

The taxpayer is entitled one-half year of depreciation in the year of acquisition and the depreciation table automatically prorates it. The depreciation percentage for the first year of 7-year property would normally be 28.6%, but the table provides only 14.3%. In other words, do not prorate in the year of acquisition; just use the percentage in the table.

Prorating Depreciation in the Year of Disposition

When the taxpayer disposes of personal property during the recovery period, the taxpayer is entitled to deduct only one-half of the applicable percentage amount in the year of disposition. In example 1, if Doran sold the furniture on December 30 in the third year, she would deduct $1,225 of depreciation that year ($2,450 x 50%).

First-year Expensing § 179

Code § 179 permits a taxpayer to elect to deduct a specified amount of the cost of tangible personal property (not real property) in the year the property is placed it in service. First-year expensing is additional depreciation in the year of acquisition. Only personal property used in a trade or business qualifies for first-year expensing. Neither real property nor personal property used for the production of income qualifies. For example, if Donald buys a safe to store his stock and bond certificates, the safe is depreciable under § 212. However, it is not eligible for first-year expensing because investing is not a trade or business and first-year expensing is only available for personal property used in a trade or business.

The maximum amount of first-year expensing available each year is listed below. The maximum amounts specified are annual amounts for all personal property placed in service during the year; the taxpayer may elect a lesser amount. However, first-year expensing cannot exceed the income from the business in the year; if the income before first-year expensing is $80,000, then only $80,000 of first-year expensing will be deductible.

<table>
<thead>
<tr>
<th>Year</th>
<th>Maximum First-Year Expensing</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$100,000</td>
</tr>
<tr>
<td>2004</td>
<td>$102,000</td>
</tr>
<tr>
<td>2005</td>
<td>$105,000</td>
</tr>
<tr>
<td>2006</td>
<td>$108,000</td>
</tr>
<tr>
<td>2007</td>
<td>$125,000 (for information only; 2006 will be the tax year for all problems)</td>
</tr>
</tbody>
</table>

Important note: Make sure to use the correct maximum amount of first-year expensing for the year the taxpayer placed the property in service. If the taxpayer acquired an asset for $250,000 in 2004, only $102,000 of first year expensing was permitted. The balance of the basis is depreciated using MACRS. The taxpayer may elect first-year expensing each year for assets acquired during the year.

Example 2

Cynthia purchased $136,000 of store fixtures (7-year property) in 2003. The maximum first-year expensing in 2003 was $100,000. She computes her depreciation deductions as follows:

<table>
<thead>
<tr>
<th>Cost</th>
<th>$136,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003 first-year expensing</td>
<td>$100,000</td>
</tr>
<tr>
<td>36,000 of basis remains for regular depreciation</td>
<td></td>
</tr>
<tr>
<td>2003 regular depreciation: $36,000 x 14.3%</td>
<td>5,148</td>
</tr>
<tr>
<td>2004: $36,000 x 24.5%</td>
<td>8,820</td>
</tr>
<tr>
<td>2005: $36,000 x 17.5%</td>
<td>6,300</td>
</tr>
<tr>
<td>2006: $36,000 x 12.5%</td>
<td>4,500</td>
</tr>
<tr>
<td>total depreciation through 2006</td>
<td>124,768 - 124,768</td>
</tr>
<tr>
<td>adjusted basis on 12/31/06</td>
<td>11,232</td>
</tr>
</tbody>
</table>
Phase-out of First-Year Expensing

Section 179(b)(2) phases out first-year expensing as the taxpayer’s total investment in personal property exceeds a specified amount in a year. The first-year expensing amounts and phaseout floors are as follows:

<table>
<thead>
<tr>
<th>1st year Expensing</th>
<th>Phaseout Floor</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003: $100,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>2004: 102,000</td>
<td>410,000</td>
</tr>
<tr>
<td>2005: 105,000</td>
<td>420,000</td>
</tr>
<tr>
<td>2006: 108,000</td>
<td>430,000</td>
</tr>
<tr>
<td>2007: 125,000</td>
<td>500,000</td>
</tr>
</tbody>
</table>

(for information only; 2006 will be the tax year)

For every dollar of personal property the taxpayer places in service in a year in excess of the phaseout floor, one dollar of first-year expensing is phased out. If Beverly acquires $429,500 of personal property during 2006, she may elect $108,000 of first-year expensing. If she acquired $470,000 of equipment in 2006, $40,000 of first-year expensing is phased out ($470,000 property acquired - $430,000 floor). In that case she can deduct $68,000 of first-year expensing ($108,000 maximum minus $40,000 phased out).

Straight-line Depreciation § 168(g)

The MACRS personal property table uses an “accelerated” depreciation method that provides larger deductions in the early years of ownership and smaller deductions in later years. If a taxpayer anticipates losses or low income in the first years of owning the asset (for example, the early years of a new business), she may prefer to deduct less depreciation than MACRS permits in those years. Section 179 first-year expensing is elective and should not be elected in low-income or loss years. That preserves basis for depreciation deductions in later years when the business is more profitable.

A business may elect the straight-line method that provides equal depreciation deductions each year. The taxpayer may elect either the original recovery period or 12 years when electing straight-line depreciation. In other words, instead of using the MACRS 7-year rate for furniture, a taxpayer may elect to use straight-line over 7 or 12 years. The straight-line method must be used for “listed property” used 50% or less for business, as will be discussed later.

To compute annual straight-line deduction, divide the adjusted basis by the recovery period (either 5 or 7 years, depending on the type of property, or 12 years if the taxpayer elects a 12-year recovery period). Only one-half of the annual amount is deductible in the year the property is acquired and one-half of the annual amount in the year of disposition.

Example 3

Kelly purchased a printing press (7-year property) for $28,000 on September 1, 2005, and elected to use the straight-line method over a 7-year period. The 2005 depreciation deduction is $2,000 ($28,000 ÷ 7 years = $4,000 per year x 50% for the year of acquisition). The deduction in each of the next six years will be $4,000 per year and the deduction in the eighth year will be the remaining $2,000 of basis. If he sells the press in 2007, the 2007 depreciation deduction will be $2,000 (one-half of the $4,000 annual amount in the year of disposition).
Listed Property

Section 280F Limitations (“listed property” -- cars and computers)

The Code imposes limitations on depreciation deductions for automobiles and certain other “listed property,” including personal computers used at home for business purposes. You are only responsible for depreciation of computers.

Computers Used More Than 50% for Business Purposes

If the computer is used more than 50% for qualified trade or business purposes, MACRS and first-year expensing may be used. Only the business portion of the basis may be depreciated. Rosenberg purchased a computer in 2006 for $4,000 that he used 70% for business. The business portion of the basis is $2,800 ($4,000 x 70%) and that amount is fully deductible under § 179 first-year expensing.

Computers Used 50% or Less for Business Purposes

If the computer is used 50% or less for trade or business purposes, neither § 179 first-year expensing nor MACRS is permitted. The taxpayer must use straight-line depreciation with a 12-year recovery period. Use of a computer for the production of income (i.e., managing of investments) is not a qualified business use because investing is not a trade or business. A personal computer used 100% to keep track of investments is not used more than 50% for “trade or business” use and the limitation applies.

Example 4

Pawlicki paid $4,800 for a personal computer in 2006 and used it 100% to analyze her investments. It is listed property not used more than 50% for business, so she must use the straight-line method over a 12-year recovery period.

The 2006 depreciation deduction is $200 ($4,800 ÷ 12 years = $400 per year x 50% for the first year). She deducts $400 each year for the next 11 years and $200 in the 13th year, if she still owns the computer. The depreciation is deductible under § 212 and is therefore a 2% MID.
Recapture of Gain on the Disposition of Personal Property

A taxpayer must determine the amount and character of gain or loss when she sells or otherwise disposes of property. Gain on the disposition of depreciable personal property is “recaptured” and reported as ordinary income to the extent of the depreciation deducted.

**Example 5**

On October 16, 2003, Garcia purchased a yacht for use as a charter fishing boat for $156,000. On January 1, 2006, she sold the yacht for $60,000. The tax consequences are determined as follows.

<table>
<thead>
<tr>
<th>cost</th>
<th>$156,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003 first-year expensing (maximum in 2003)</td>
<td>$100,000</td>
</tr>
<tr>
<td>$56,000 of basis remains for regular depreciation</td>
<td></td>
</tr>
<tr>
<td>2003: $56,000 x 14.3%</td>
<td>8,008</td>
</tr>
<tr>
<td>2004: $56,000 x 24.5%</td>
<td>13,720</td>
</tr>
<tr>
<td>2005: $56,000 x 17.5%</td>
<td>9,800</td>
</tr>
<tr>
<td>2006: $56,000 x 12.5% x 50% (in year of disposition)</td>
<td>3,500</td>
</tr>
</tbody>
</table>

**total depreciation**

<table>
<thead>
<tr>
<th>adjusted basis</th>
<th>$20,972</th>
</tr>
</thead>
<tbody>
<tr>
<td>amount realized</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>less adjusted basis</td>
<td>- 20,972</td>
</tr>
<tr>
<td>gain on sale</td>
<td>$ 39,028</td>
</tr>
</tbody>
</table>

Depreciation deductions exceed the gain, so the entire gain is recaptured as ordinary income. The $39,028 gain is entered in the ordinary income column of the tax computation worksheet.

**Reason for the Rule**

Garcia bought the yacht for $156,000 and sold it for $60,000, so it cost her $96,000 to use it. The Code permitted her to deduct $135,028 of depreciation from her income, which is $39,028 more than the $96,000 it cost her to use it. The entire gain on the disposition is attributable to the $39,028 of “extra” depreciation the Code permitted her to deduct. If she were in the 28% bracket, the extra depreciation saved her $10,928 of tax during the time she owned the property ($39,028 x 28%).

Gain on the disposition of depreciable personal property is ordinarily characterized as long-term capital gain (LTCG), which is taxed at a maximum rate of 5% or 15%, depending on the taxpayer’s tax bracket. Assuming the capital gain is taxed at 15%, if it wasn’t for the recapture provision, the tax on the $39,028 would be $5,854 of tax ($39,028 x 15%). As indicated above, the extra depreciation saved her $10,928 of tax at the 28% regular rate. Thus she would have gained $5,074 from the disparity in rates ($10,928 saved from the extra depreciation deductions minus $5,854 tax on the gain at the 15% capital gain rate).

The recapture provision eliminates the tax savings from excess depreciation deductions. The $39,028 gain is taxed at her regular rates, instead of the lower capital gain rates. This eliminates the tax gain she would have from the disparity in rates described in the previous paragraph.
**Sale of Part-Business, Part-Personal Use Property**

When property is used partly for business and partly for personal purposes, consider the property as two separate assets for tax purposes: a business asset, which can be depreciated, and a personal asset that is not depreciable. The rules for the disposition of *business* property apply to the business asset and the nonbusiness rules apply to the disposition of the personal portion of the asset. The following example will illustrate the computation.

**Example 6**

On June 1, 2004, Donnelly purchased an $8,000 computer, used 75% for business purposes and 25% for personal purposes. The business basis of the computer is $6,000 and the personal basis is $2,000. The computer is 5-year property and he did not elect first-year expensing or the 50% bonus. In 2006, he sold the computer for $5,000. A computer is *listed* property as previously explained, but since it is used more than 50% for business purposes, MACRS and first-year expensing are available. The tax consequences are as follows:

<table>
<thead>
<tr>
<th></th>
<th>75%</th>
<th>25%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$8,000 computer cost</td>
<td>$6,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2004: 6,000 x 20%</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>2005: 6,000 x 32%</td>
<td>1,920</td>
<td></td>
</tr>
<tr>
<td>2006: 6,000 x 19.2% ÷ 2</td>
<td>576</td>
<td></td>
</tr>
<tr>
<td><strong>total depreciation</strong></td>
<td>3,696</td>
<td>-3,696</td>
</tr>
<tr>
<td><strong>adjusted basis</strong></td>
<td>2,304</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>$5,000 amount realized</strong></td>
<td>3,750</td>
<td>1,250</td>
</tr>
<tr>
<td><strong>less adjusted basis</strong></td>
<td>-2,304</td>
<td>-2,000</td>
</tr>
<tr>
<td><strong>gain (loss)</strong></td>
<td>$1,446</td>
<td>($750)</td>
</tr>
</tbody>
</table>

The $1,446 gain on the business asset is ordinary income because of recapture of depreciation and is entered in the ordinary income column of the tax computation worksheet. The $750 loss on the personal asset is not deductible because it is a loss on the sale of a personal asset.
**Depreciation of Automobiles** (for your information only)

**Incentives for Environmentally-friendly Vehicles**

**Hybrids**

Hybrid fuel vehicles began to qualify for tax credits in 2006. However, after each manufacturer sells its 60,000th hybrid vehicle (not per model), the credits are reduced by 50% beginning on the first day of the second calendar quarter after the trigger is hit. For example, the Toyota Prius qualified for a $3,150 tax credit from 1/1/06-9/30/06. From April 1 through September 30, 2007, the credit is $787.50.

(a) **Depreciation Method**

Autos are “listed property” and the listed property rules previously discussed are applicable. If the car is used 50% or less for business, it must be depreciated over a 5-year period using the straight-line method. In addition, the depreciation cannot exceed the dollar limitations discussed below. If a car is used more than 50% for business, accelerated depreciation and first-year expensing are permitted, but the deductions are still subject to the following dollar limitations.

(b) **Dollar limitations for cars used 100% for business**

For cars placed in service in 2007, the maximum depreciation deduction (including both regular and first-year expensing) is as follows: year 1: $3,060; year 2: $4,900; year 3: $2,850; year 4 and after that: $1,775. Vans, trucks, SUVs, and electric vehicles have different limits. The limitations are adjusted from time to time but they remain constant for a particular asset. A car placed in service in 2005 is subject to the limits that are applicable that year.

**Standard Mileage Rate**

Instead of deducting depreciation, maintenance and other operating costs, a taxpayer can deduct 48½¢ cents for each business mile driven in 2007 (up from 44½ cents in 2006. The business portion of parking and tolls may be deducted in addition to the standard mileage rate.
DEPRECIATION OF REAL PROPERTY

Recovery periods

The Code classifies real property as residential (apartment buildings), or nonresidential (factories, warehouses, etc.). Residential real property is depreciated over 27½ years; nonresidential property is depreciated over 39 years. Only real property used for business or investment purposes can be depreciated. Depreciation deductions are not permitted for real property used for personal purposes, such as a personal residence.

Calculating Depreciation on Real Property

Table 1  Residential Real Property

<table>
<thead>
<tr>
<th>Year</th>
<th>0.03485</th>
<th>0.03182</th>
<th>0.02879</th>
<th>0.02576</th>
<th>0.02273</th>
<th>0.01970</th>
<th>0.01667</th>
<th>0.01364</th>
<th>0.01061</th>
<th>0.00758</th>
<th>0.00455</th>
<th>0.00152</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
<td>0.03636</td>
</tr>
</tbody>
</table>

Table 2  Nonresidential Real Property

<table>
<thead>
<tr>
<th>Year</th>
<th>0.02461</th>
<th>0.02247</th>
<th>0.02033</th>
<th>0.01819</th>
<th>0.01605</th>
<th>0.01391</th>
<th>0.01177</th>
<th>0.00963</th>
<th>0.00749</th>
<th>0.00535</th>
<th>0.00321</th>
<th>0.00107</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
<td>0.02564</td>
</tr>
</tbody>
</table>

To calculate the depreciation deduction, multiply the original basis of the property by the amount shown in the column under the month the taxpayer acquired the building.

Example 7

Capelli purchased a factory for $1 million on October 1, 2006; $100,000 was allocated to the land. The 2006 depreciation deduction is $4,815 ($900,000 basis of the building x 0.00535, the percentage in the 10 (October) column for the first year in Table 2 for non-residential property). The deduction for each successive year is $23,076 ($900,000 x 0.02564, the percentage in the 10 column for years 2-39).

Proration of Depreciation in the Year of Disposition

In the year a taxpayer sells a building, the depreciation deduction is prorated according to the number of months it was owned in the year of disposition. Divide the annual depreciation amount by 12 to determine the monthly amount, then multiply the monthly amount by the number of months held in the year. Real property is considered sold in the middle of the month of disposition, so one-half of the monthly depreciation is deductible for the month of disposition.

Example 8

Capelli sells the factory on April 1, 2008. She computes the 2008 deduction as follows: $23,076 annual deduction ÷ 12 months = $1,923 monthly depreciation. She owned the factory for 3½ months (one-half month for the month of disposition). $1,923 monthly depreciation x 3.5 months = $6,731 for 2006.
Example 9

Rothbart acquired an apartment building on May 17, 2003 for $450,000 ($50,000 allocated to the land) and sold the land and building on October 2, 2006 for $550,000. Rothbart calculates depreciation and the gain on sale as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Adjusted Basis</th>
<th>Basis of Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>400,000 x 0.02273 - 9,092</td>
<td>350,306</td>
<td>400,306</td>
</tr>
<tr>
<td>2004</td>
<td>400,000 x 0.03636 - 14,544</td>
<td>350,306</td>
<td>400,306</td>
</tr>
<tr>
<td>2005</td>
<td>400,000 x 0.03636 - 14,544</td>
<td>350,306</td>
<td>400,306</td>
</tr>
<tr>
<td>2006</td>
<td>- 11,514 *</td>
<td>350,306</td>
<td>400,306</td>
</tr>
</tbody>
</table>

* 2006 deduction: $14,544 annual ÷ 12 = $1,212 per month x 9½ months = $11,514.

Character of Gain on the Disposition of Real Property

Gain on the sale of depreciable real property is treated as long-term capital gain (LTCG), taxed at a maximum rate of 5 or 15%. However, the gain attributable to depreciation deductions is recaptured. The taxpayer deducted depreciation at ordinary income rates, but without the recapture provision, the gain attributable to those deductions would be taxed at 5 or 15%.

Depreciation recaptured on personal property is taxed at the regular tax rate, but depreciation recaptured on the sale of real property is taxed at a maximum rate of 25%. The gain recaptured is real estate long-term capital gain (RE LTCG) and is entered in the RE LTCG column of the tax computation worksheet. We will study how capital gains and losses are taxed later in the course.

In example 9, Rothbart deducted $49,694 of depreciation, so the first $49,694 of gain is attributable to the depreciation deductions. This gain is recaptured and entered in the RE LTCG column. The remaining $100,000 of the gain is entered in the LTCG(L) column.

Example 10

Sullivan purchased a condominium for investment purposes several years ago for $140,000. Over the years, he deducted $40,000 of depreciation making the adjusted basis $100,000 at the time he sold it in 2006 for $137,000.

<table>
<thead>
<tr>
<th>Cost</th>
<th>$140,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>- 40,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>100,000</td>
</tr>
<tr>
<td>Amount Realized</td>
<td>$137,000</td>
</tr>
<tr>
<td>Less Adjusted Basis</td>
<td>- 100,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$37,000</td>
</tr>
</tbody>
</table>

The depreciation deductions exceeded the gain so the entire $37,000 gain is recaptured and entered in the RE LTCG column of the worksheet.
2006 DEPRECIATION AMOUNTS

PERSONAL PROPERTY

First-Year Expensing

<table>
<thead>
<tr>
<th></th>
<th>Maximum</th>
<th>Phaseout Floor</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003:</td>
<td>100,000</td>
<td>400,000</td>
</tr>
<tr>
<td>2004:</td>
<td>102,000</td>
<td>410,000</td>
</tr>
<tr>
<td>2005</td>
<td>105,000</td>
<td>420,000</td>
</tr>
<tr>
<td>2006</td>
<td>108,000</td>
<td>430,000</td>
</tr>
</tbody>
</table>

Personal Property Cost Recovery Rate

<table>
<thead>
<tr>
<th>Recovery year</th>
<th>Applicable percentage</th>
<th>5-year property</th>
<th>7-year property</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>20.0%</td>
<td>14.3%</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>32.0%</td>
<td>24.5%</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>19.2%</td>
<td>17.5%</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>11.5%</td>
<td>12.5%</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>11.5%</td>
<td>8.9%</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>5.8%</td>
<td>8.9%</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>8.9%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>4.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>100.0%</td>
<td>100.0%</td>
<td></td>
</tr>
</tbody>
</table>

REAL PROPERTY

Table 1 Residential Real Property

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.03485</td>
<td>.03182</td>
<td>.02879</td>
<td>.02576</td>
<td>.02273</td>
<td>.01970</td>
<td>.01667</td>
<td>.01364</td>
<td>.01061</td>
<td>.00758</td>
<td>.00455</td>
<td>.00152</td>
</tr>
<tr>
<td>2-27½</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
<td>.03636</td>
</tr>
</tbody>
</table>

Table 2 Nonresidential Real Property

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.02461</td>
<td>.02247</td>
<td>.02033</td>
<td>.01819</td>
<td>.01605</td>
<td>.01391</td>
<td>.01177</td>
<td>.00963</td>
<td>.00749</td>
<td>.00535</td>
<td>.00321</td>
<td>.00107</td>
</tr>
<tr>
<td>2-39</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
<td>.02564</td>
</tr>
</tbody>
</table>
DEPRECIATION PROBLEMS

For these problems and on the exam, always assume the taxpayer will elect the MACRS method and first-year expensing, if they are available for the type of property acquired.

Problem 1
Weiss acquired a machine (7-year property) on February 1, 2004 for $140,000 and used it 100% for business purposes. The machine has a 10-year useful life and a $34,000 salvage value. He sold the machine on March 15, 2006 for $50,000. Determine the amount and character of the gain or loss on the sale.

Problem 2
Gaynor purchased a computer system (5-year property) on March 1, 2003 for $160,000 and used it 80% for business purposes. He sold the computer on January 2, 2006 for $40,000. Determine the amount and character of the gain or loss on the sale.

Problem 3
Rogers purchased a computer on March 1, 2004 for $28,000 and used it 100% to analyze her extensive investments. She sold the computer on November 10, 2006. How much depreciation can she deduct in 2004, 2005 and 2006 and how should they be characterized (adjustments, regular itemized, or 2% MIDs)?

Problem 4
Digman purchased $1,000,000 of new equipment (5-year property) in 2004, used it 100% for business purposes, and abandoned it as worthless in 2006. What are the tax consequences in 2006? (The loss equals her basis at the time she abandoned it.)

Problem 5
Windmiller acquired an apartment building for $360,000 on August 1, 2004, paying $55,000 in cash and obtaining a non-recourse mortgage loan from a bank for the balance. $30,000 of the purchase price was allocated to the land. She sold the building and land on March 2, 2006 for $400,000. What is the amount and character of her gain or loss on the sale?
SOLUTIONS TO DEPRECIATION PROBLEMS

Problem 1

Weiss acquired a machine (7-year property) on February 1, 2004 for $140,000 and used it 100% for business purposes. The machine has a 10-year useful life and a $34,000 salvage value. He sold the machine on March 15, 2006 for $50,000. Determine the amount and character of the gain or loss on the sale.

<table>
<thead>
<tr>
<th>cost</th>
<th>$140,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 first-year expensing</td>
<td>$102,000</td>
</tr>
<tr>
<td>$38,000 basis remains for regular depreciation</td>
<td></td>
</tr>
<tr>
<td>2004 regular depreciation: $38,000 x 14.3%</td>
<td>5,434</td>
</tr>
<tr>
<td>2005: $38,000 x 24.5%</td>
<td>9,310</td>
</tr>
<tr>
<td>2006: $38,000 x 17.5% ÷ 2</td>
<td>3,325</td>
</tr>
<tr>
<td>total depreciation</td>
<td>120,069</td>
</tr>
<tr>
<td>adjusted basis</td>
<td>$19,931</td>
</tr>
</tbody>
</table>

amount realized | $50,000 |
less adjusted basis | - 19,931 |
gain on sale | $30,069 (ordinary income because of recapture of depreciation)

In 2006, the $30,069 gain is entered in the ordinary income column of the tax computation worksheet and $3,325 of depreciation is entered in the regular adjustments column.

Problem 2

Gaynor purchased a computer system (5-year property) on March 1, 2003 for $160,000 and used it 80% for business purposes. He sold the computer on January 2, 2006 for $40,000. Determine the amount and character of the gain or loss on the sale.

| cost: $160,000 |
| 80% Business | $128,000 |
| 20% Personal | $32,000 |
| 2003 first-year expensing | $100,000 |
| $28,000 basis for regular depreciation ($128,000 - $100,000) |
| 2003 regular depreciation ($28,000 x 20%) | 5,600 |
| 2004 depreciation ($28,000 x 32%) | 8,960 |
| 2005 depreciation ($28,000 x 19.2%) | 5,376 |
| 2006 depreciation ($28,000 x 11.5% x ½) | 1,610 |
| total depreciation | 121,546 |
| adjusted basis | $6,454 |
| 80% Business | $32,000 |
| 20% Personal | $8,000 |
| amount realized ($40,000) | $32,000 |
| less adjusted basis | - 6,454 |
| gain or loss | $25,546 ($24,000) |

The $25,546 gain on the business portion of the asset is ordinary income because of recapture of depreciation. In 2006, Gaynor will enter $25,546 in the ordinary income column of the worksheet and $1,610 of depreciation in the regular adjustment column of the worksheet. The $24,000 loss on the sale of the personal portion of the asset is a nondeductible personal loss.
Problem 3

Rogers purchased a computer on March 1, 2004 for $28,000 and used it 100% to analyze her extensive investments. She sold the computer on November 10, 2006. What is her depreciation deduction for 2004, 2005 and 2006 and how should she deduct them (adjustment, regular itemized, or a 2% MID)?

This is listed property not being used more than 50% for a trade or business so § 179 first-year expensing and MACRS are not available. The computer is depreciated using the straight-line method over a 12-year recovery period. The annual depreciation deduction is $2,333 ($28,000 ÷ 12). However, in the years of acquisition and disposition, only one-half year is deductible.

- 2004: $1,167 ($2,333 x 50% in the year of acquisition)
- 2005: $2,333
- 2006: $1,167 ($2,333 x 50% in the year of disposition)

The property is being used for the production of income so the depreciation deductible under § 212, which makes it a 2% MID.

Problem 4

Digman purchased $1,000,000 of new equipment (5-year property) in 2004, used it 100% for business purposes, and abandoned it as worthless in 2006. What are the tax consequences in 2006? (The loss equals her basis at the time she abandoned it.)

<table>
<thead>
<tr>
<th>Year</th>
<th>Computation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>1,000,000 x 20%</td>
<td>$200,000</td>
</tr>
<tr>
<td>2005</td>
<td>1,000,000 x 32%</td>
<td>$320,000</td>
</tr>
<tr>
<td>2006</td>
<td>1,000,000 x 19.2% ÷ 2</td>
<td>$96,000</td>
</tr>
<tr>
<td>total depreciation</td>
<td></td>
<td>$616,000</td>
</tr>
<tr>
<td>adjusted basis</td>
<td></td>
<td>$384,000</td>
</tr>
</tbody>
</table>

When a taxpayer abandons property as worthless, the balance of the basis is deductible so in 2006, she deducts a loss of $384,000 plus depreciation expense of $96,000.

*The maximum first-year expensing in 2004 is $102,000 and first-year expensing is phased out dollar for dollar as property placed in service exceeds $410,000. First-year expensing is totally phased out in 2004 if property placed in service exceeded $512,000. ($512,000 property acquired minus $410,000 phaseout floor equals $102,000 phased out, the maximum amount of first-year expensing.) Digman placed more than $512,000 in service so the entire $102,000 first-year expensing is phased out.
Problem 5

Windmiller acquired an apartment building for $360,000 on August 1, 2004, paying $55,000 in cash and obtaining a non-recourse mortgage loan from a bank for the balance. $30,000 of the purchase price was allocated to the land. She sold the building and land on March 2, 2006 for $400,000. What is the amount and character of her gain or loss on the sale?

<table>
<thead>
<tr>
<th>Basis of Building</th>
<th>$330,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 depreciation (330,000 x .01364)</td>
<td>$4,501</td>
</tr>
<tr>
<td>2005 depreciation (330,000 x .03636)</td>
<td>11,999</td>
</tr>
<tr>
<td>2006 depreciation (330,000 x .03636 ÷ 12 = $1,000/month x 2½ months)</td>
<td>2,500</td>
</tr>
<tr>
<td>Total depreciation deducted</td>
<td>19,000</td>
</tr>
<tr>
<td>Adjusted basis of building</td>
<td>$311,000</td>
</tr>
<tr>
<td>Add $30,000 basis of the land</td>
<td>+ 30,000</td>
</tr>
<tr>
<td>Adjusted basis of land and building</td>
<td>$341,000</td>
</tr>
</tbody>
</table>

| Amount Realized for Land and Building | $400,000 |
| Less Adjusted Basis | -341,000 |
| Equals Gain on Sale | $59,000 |

$19,000 of the gain is RE LTCG (the amount of the depreciation deductions) and the $40,000 balance is LTCG.

In 2006, Windmiller enters the following amounts in the worksheet:

- $2,500 in the regular adjustment column for 2006 depreciation
- $19,000 in the RE LTCG column
- $40,000 in the LTCG column

Reconciliation

| Sold for | $400,000 |
| Purchased for | 360,000 |
| Economic Gain | $40,000 |
| Tax Gain on Disposition | $59,000 |
| Less Taxable Income Reduction from Depreciation Deductions | -19,000 |
| Equals Net Tax Gain | $40,000 |
Solution to Casebook Depreciation Problem 4 on 298

On March 30 of the current year [2006], Pete purchased and placed in service an apartment building for $500,000. He paid $50,000 down on the property and agreed to pay the balance in installments over the next 20 years. $100,000 of the $500,000 cost is allocable to the land and the other $400,000 to the building.

(a) May Pete claim a § 179 deduction with respect to the purchase of the apartment building?

No. § 179 first-year expensing is only available for depreciable personal property.

(b) How much depreciation may Pete claim on the apartment building in the year of purchase?

How much depreciation may he claim the following year? (Assume that all of the gross rental income Pete receives from the building is rental income from dwelling units.)

The building is residential property acquired in March so use the third column of Table 1.

<table>
<thead>
<tr>
<th>cost of building</th>
<th>$400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 depreciation:</td>
<td>400,000 x .02879</td>
</tr>
<tr>
<td>2007 depreciation:</td>
<td>400,000 x .03636</td>
</tr>
<tr>
<td>adjusted basis after 2007</td>
<td>373,940</td>
</tr>
</tbody>
</table>

From the syllabus:

(c) Pete sold the land and building on January 3, 2008 for $600,000. Determine the amount and character of his gain or loss on the disposition.

<table>
<thead>
<tr>
<th>cost of building</th>
<th>$400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 depreciation:</td>
<td>400,000 x .02879</td>
</tr>
<tr>
<td>2007 depreciation:</td>
<td>400,000 x .03636</td>
</tr>
<tr>
<td>2008 depreciation*</td>
<td>- 606</td>
</tr>
<tr>
<td>total depreciation</td>
<td>26,666</td>
</tr>
<tr>
<td>basis of building</td>
<td>373,334</td>
</tr>
<tr>
<td>add basis of the land</td>
<td>+ 100,000</td>
</tr>
<tr>
<td>basis of building and land</td>
<td>$473,334</td>
</tr>
</tbody>
</table>

*2008 depreciation is $606 ($14,544 annual amount ÷ 12 = $1,212/month x ½ month)

Calculation of Gain or Loss

<table>
<thead>
<tr>
<th>amount realized</th>
<th>$600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>- adjusted basis</td>
<td>-473,334</td>
</tr>
<tr>
<td>gain</td>
<td>$126,666</td>
</tr>
</tbody>
</table>

$26,666 of the gain is RE LTCG (the amount of the depreciation deductions); the $100,000 balance of the gain is LTCG.

Summary

In 2008, Pete will make the following entries in the tax computation worksheet:

- $606 in the regular adjustment column for the depreciation expense
- $26,666 in the RE LTCG column
- $100,000 in the LTCG column
SALE OF PROPRIETORSHIP ASSETS

Trujillo agreed to sell the assets of her clothing store, a sole proprietorship, to Wilding for $900,000. Trujillo will sign a covenant not to compete with Wilding for three years within a ten mile radius of the store.

(a) If you represent the seller, how would you want the sales price to be allocated to the following assets?

(b) What allocations would the buyer’s attorney be negotiating for?

**Land:** basis: $50,000; FMV between $90,000 and $110,000
   - **Seller:** maximum; taxed as LTCG
   - **Buyer:** minimum; not depreciable

**Furniture & Fixtures:** cost: $50,000; adjusted basis: $15,000; FMV between $20,000 and $30,000
   - **Seller:** minimum; gain is ordinary income because of recapture
   - **Buyer:** maximum; depreciated over a relatively short 5 or 7 years

**Inventory:** basis: $50,000; FMV between $40,000 and $60,000
   - **Seller:** minimum; taxed as ordinary income when sold
   - **Buyer:** maximum to reduce the profit when the inventory is sold to customers

**Building:** cost $300,000; adjusted basis $200,000; FMV between $300,000 and $400,000
   - **Seller:** prefers higher allocation to building than equipment; (25% rate on recaptured depreciation for real estate; ordinary income on recaptured depreciation on personal property) Prefers higher allocation to goodwill than to either building or equipment.
   - **Buyer:** depreciable over 27½ or 39 years; prefers higher allocation to equipment, which is depreciated over 5 or 7 years, or goodwill, amortizable over 15 years

**Goodwill**
   - **Seller:** maximum; taxed as LTCG
   - **Buyer:** indifferent between goodwill and covenant not to compete (both amortized over 15 years); in exchange for higher allocation to goodwill and less to covenant not to compete, the buyer will negotiate for higher allocation to inventory and equipment; less to land than to building

**Covenant not to Compete**
   - **Seller:** minimum; taxed as ordinary income
   - **Buyer:** same as the buyer’s position for goodwill
CONVERSION OF A PERSONAL RESIDENCE TO RENTAL PROPERTY

When property is converted from a personal residence to rental property, if the FMV exceeds the original basis, the original cost is used for purposes of depreciation deductions and determining gain or loss on the sale. If the property has declined in value (the FMV is less than the original basis at the time of conversion), the FMV is used for purposes of depreciation and is used for purposes of determining a loss on the sale. The decline in value while the property is being used as a residence is a nondeductible personal loss. When the property is sold, Reg. § 1.165-9, discussed on 346-347 applies. Use the following steps to determine the gain or loss:

Step 1. Subtract depreciation deductions from the original cost of the property to calculate the adjusted basis for purposes of a gain. Subtract this adjusted basis from the amount realized; if the result is a gain, it is included in gross income. If the result is a loss, go to step 2.

Step 2. Subtract depreciation deductions from the FMV of the property at the time of conversion to get the adjusted basis for purposes of a loss. Subtract this adjusted basis from the amount realized and if the result is a loss, the loss is deductible as a capital loss.

Step 3. If there is no gain under step 1 and no loss under step 2, then there is no gain or loss on the sale.

Example 1

(1) **FMV exceeds basis of home at time of conversion**
Basis of home: $250,000
FMV on date of conversion: $275,000
Basis for depreciation deductions and gain or loss: $250,000.

(2) **Basis of home exceeds FMV at time of conversion**
Basis of home: $250,000
FMV on date of conversion: $200,000
Gain basis: $250,000 basis of home - depreciation deductions
Loss basis: $200,000 FMV at conversion - depreciation deductions
The $50,000 decline in value represents a personal, nondeductible loss, so the basis for depreciation is $200,000, FMV on date of conversion.
**Example 2**

Midland purchased a home for $250,000 in 1995. In October 2001, he moved out and began renting the property when the FMV was $200,000. He sold the home in February 2006.

**Depreciation deductions:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$1,516</td>
<td>($200,000 x .00758)</td>
</tr>
<tr>
<td>2002 to 2005</td>
<td>29,088</td>
<td>($200,000 x .03636 = $7,272 x 4 years)</td>
</tr>
<tr>
<td>2006</td>
<td>909</td>
<td>($7,272 ÷ 12 = $606 x 1½ months)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$31,513</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Gain basis:** $250,000 cost - $31,513 depreciation = $218,487  
**Loss basis:** $200,000 FMV - $31,513 depreciation = $168,487

**Midland sells home for:**

- $258,487 gain is $40,000 ($258,487 - 218,487)
- $158,487 loss is $10,000 ($158,487 - 168,487)
- $200,000 no gain or loss.

His loss would be $18,487 using the $218,487 basis. However, the first $50,000 of loss is attributable to the decline in value while he was using the home as his personal residence, so the loss is not deductible.

The $200,000 sale price is less than the $218,487 basis; no gain on the transaction.

**Basis for Loss on Sale of Residence is Similar to Gift Loss Rule**

Mom pays $20,000 for stock and gives it to her daughter when the FMV is $15,000. The $5,000 decline in value while mom held the stock cannot be transferred to the daughter.

Daughter sells the stock for:

- $22,000 $2,000 gain
- $12,000 $3,000 loss
- $17,000 no gain or loss;  
  The loss is attributable to decline in value while mom held the stock.  
  Mom paid $20000 and stock was sold for $17,000, so there is no gain on the deal.

**Summary**

No gain or loss occurs when the loss is not deductible for a policy reason. In the sale of residence situation, the personal loss is not deductible. In the gift situation, mom’s loss cannot be transferred to daughter.
PROBLEMS

Problem 1
The Convisers purchased a home Riverwoods for $400,000 in 1994. On November 10, 2004, they retired to Arizona and put their home up for sale for $1.4 million, its approximate fair market value. On January 19, 2006, they sell the home for $1.2 million.

A. What is the amount and character of their gain?

B. Same facts, but they sold it for $300,000. How much loss can they deduct?

C. Same as part B, but they attempted to rent or sell the home beginning in 2004. They were not able to rent it.
   (1) Can they deduct maintenance and depreciation on the home?
   (2) Can they deduct the $100,000 loss on the sale?

D. Same as part C, but they rented the property in 2005. Can they deduct the loss on the sale?

Problem 2
The Spaks purchased a home in 1991 for $100,000 and began renting it in 2002 when the FMV was $75,000. While renting it, they properly deducted $5,000 of depreciation. What is their gain or loss if they sell the home for the following amounts?

(a) $110,000
(b) $90,000
(c) $60,000
TRAVEL PROBLEMS

Determine how much of the following expenses are deductible and whether the expenses are deductible as adjustments, regular itemized deductions, or 2% MIDs.

1. (a) Gladstein spent $200 for a commuter monthly pass to travel from his suburban home to his Chicago law office. See Regs. § 1.262-1(b)(5).

   (b) Gladstein’s employer reimbursed him $120 each month for the commuter pass. See Code §§ 132(f)(1)(B), 132(f)(2)(A); the inflation-adjusted limit is $105 in 2006.

2. Fayne drove to work and paid $275 per month to park; his employer reimbursed him $250 per month. See §§ 132(f)(1)(C), 132(f)(2)(B); the inflation-adjusted limit is $205 in 2006.

3. Two nights a week, Brower spends $10 to take a cab from her law office to Kent where she is pursuing an LL.M. degree in taxation. See item (a) at the bottom of p. 365.

4. Kieszkowski maintains a home in Chicago where she lives with her husband and two children. She works two days a week in Chicago and three days a week at the company’s St. Louis office. She maintains an apartment in St. Louis and spends two nights a week there. She spends $150 a week on airfare, $80 a week for meals and living expenses in St. Louis and $700 a month on rent. See § 162(a)(2) and read the middle paragraph on page 373; the same rule applies if the taxpayer works in two different locations all year.

5. Professor Eglit taught in our semester-abroad program in London and spent $15,000 for travel, rent and meals. How much may he deduct? Read from the last paragraph on 371 to 372.

6. Weiss flew to New York at 9:00 a.m. to attend a business meeting. He spent $45 for lunch and returned to Chicago at 5:00 p.m. Read the first full paragraph on p. 369.

7. (a) Dyme drove to Champaign to attend a continuing legal education seminar that ended at 8:00 p.m. He stayed overnight and returned to Chicago at noon the next day. He spent $100 for the seminar, $50 for meals, $75 for the hotel, and $25 for car expenses. See §§ 162(a)(2); 274(n).

   (b) Same as (a), but he drove home at the end of the seminar, had dinner on the road, and arrived home at 11:00 p.m.

   (c) Same as (a), but the seminar ended at 4:30 p.m. and he could have easily returned home the same day without staying overnight.

8. On a Monday in January, Engert flew from Chicago to a business meeting in Florida. The meeting ended late Wednesday and she returned Sunday evening after enjoying a few days in the sun. She spent $500 on airfare, $200 for lodging and $100 for meals per day. See Regs. § 1.162-2(a) and (b)(1) and (2).

9. Laho flew to Madrid Wednesday, conducted business Friday and the following Monday and returned to Chicago the following Friday night. She spent $1,000 on airfare, $200 a day for lodging and $100 a day for meals. See Reg. § 1.274-4(c), (d)(1), (d)(2) through the first sentence of (d)(2)(i) and § 1.274(d)(2)(v).
ADDITIONAL INFORMATION ABOUT EDUCATION TAX INCENTIVES

A. Hope CREDIT

The inflation-adjusted amount of the Hope credit is 100% of the first $1,100 of qualified tuition and related expenses and 50% of the next $1,100 of qualified expenses.

B. § 222 Tuition DEDUCTION

Tuition expenses that are deductible under § 222 are entered in the “§ 221 & 222 Adjustments” column of the tax computation worksheet.

C. Computing the Phaseout

The Hope credit and Lifetime Learning Credits (LLC) are phased out between AGI of $45,000 - $55,000 for a single taxpayer and $90,000 - $110,000 for married taxpayers in 2006. These amounts are adjusted for inflation each year. (For 2007 the phaseouts are $47,000 - $57,000 and $94,000 - $114,000.) If the taxpayer’s AGI is within the phaseout ranges, calculate the credit as follows:

1. determine the credit before phaseout;
2. subtract AGI from the $55,000 or $110,000 ceiling;
3. divide the result in step 2 by $10,000 for single or $20,000 for married taxpayers;
4. multiply the percentage in step 3 by the credit in step 1; the result is the credit remaining.

Example 1

The Martins’s AGI is $95,000 and they paid $1,700 of tuition for their son’s second year in junior college. They compute the Hope credit as follows:

1. $1,400 credit before phaseout (100% of the first $1,100 plus 50% of the remaining $600);
2. $110,000 ceiling - $95,000 AGI = $15,000;
3. $15,000 ÷ $20,000 = 75%;
4. $1,400 x 75% = $1,050 Hope credit remaining.

D. Employer Reimbursements

1. Non-Deductible Tuition

When an employer reimburses an employee for tuition that is not deductible under § 162, $5,250 of the reimbursement is excluded under § 127 and the balance is included in gross income. The amount included in income is considered tuition paid by the employee. This amount is added to the actual tuition paid by the employee for purposes of § 25A credits and the § 222 deduction.

2. Deductible Tuition (for your information only)

If the tuition is deductible under § 162, the entire amount reimbursed by the employer is excluded under § 132(a)(3) as a working condition fringe benefit. If the employer does not reimburse the full amount of tuition, there are several ways the taxpayer can handle tuition he paid himself on the tax return. The employee should determine which of the following options provides the best tax result: (1) deduct some tuition under § 222 and the balance under § 162 as an employee business expense (2% MID); (2) use $10,000 for the LLC and deduct the balance, if any, as a business expense; (3) deduct the entire amount as a § 162 business expense.
E General Rules

1. Qualifying tuition expenses may be deducted under § 222, subject to the AGI limit, or used for the § 25A credit, subject to phaseout. A taxpayer who is eligible for both the § 25A educational credits and the § 222 deduction must determine which one provides the better tax result. The § 222 deduction is entered in the “§ 221 & 222 adjustment” column of the tax computation worksheet.

2. Only $10,000 of qualifying expenses are eligible for the LLC and $4,000 (or $2,000, depending on the § 222 MAGI) of expenses are eligible for § 222 on a tax return, no matter how many taxpayers in the family incurred qualified expenses.

3. If a student may be claimed as a dependent on his parents’ tax return, only the parents may use the § 25A credits for the student’s qualified expenses (unless the parents waive the exemption).

4. A § 25A credit may be used by one student in the family and a § 222 deduction by another student.

Example 2

Silver paid $12,000 for law school tuition and his employer reimbursed him $8,000. Silver’s AGI before the reimbursement was $43,000 and he had no itemized deductions. $5,250 of the $8,000 reimbursement is excluded and the remaining $2,750 is gross income, increasing his AGI to $45,750. Assume he is in the 25% tax bracket. He paid $6,750 of tuition ($4,000 out-of-pocket plus $2,750 of the employer’s reimbursement included in his income) and must choose between the § 222 deduction and the § 25A lifetime learning credit.

tax savings from § 222: $1,000 ($4,000 deduction x 25% bracket)
tax savings from LLC: $1,249, computed as follows:
   1. $6,750 qualified expenses x 20% = $1,350 credit before phaseout
   2. $55,000 ceiling - $45,750 AGI = $9,250
   3. $9,250 ÷ $10,000 = 92.5% of credit remaining
   4. $1,350 x 92.5% = $1,249

The Lifetime Learning credit provides more tax savings than the § 222 tuition deduction.
EDUCATIONAL INCENTIVE PROBLEMS

Problem 1
Priest, an unmarried museum employee with a bachelor’s degree in archeology, spent $7,000 to take college courses in personal income tax for his personal knowledge. His AGI is $42,250 and his taxable income is $33,800 ($42,250 - $5,150 standard deduction - $3,300 exemption). Refer to h/o 1 for single taxpayers and note that taxable income of $33,800 is in the 25% bracket. What educational incentives is he entitled to and how much tax savings will each incentive provide? See §§ 25A(c)(2)(B) and 222(d)(1) for the definitions of “qualified tuition.”

Problem 2
Warren, an unmarried CPA who works for an accounting firm, paid $18,000 for law school tuition to improve his skills as an accountant. His employer reimbursed him for $13,250 of the tuition. Before these transactions, Warren’s AGI is $31,500 and he had no itemized deductions; he is in the 25% bracket. What alternatives are available and how should he report these transactions on his 2006 return to pay the lowest tax?

Problem 3
Emily and her husband Alan spent $8,000 and $4,800 respectively on law school tuition. Their AGI is $95,000 and they have no itemized deductions. They are in the 25% tax bracket. Determine if §§ 25A, 222 or a combination will provide the best tax result.

Problem 4
Same as problem 4, except Alan had never gone to college and he spent the $4,800 for tuition for his first year of college.

Problem 5
The Baileys have an AGI of $147,000 and paid $20,000 in tuition for their son who is a college senior. What educational incentives are they entitled to and how much tax savings will result from each? They are in the 28% bracket.
Problem 1
Priest, an unmarried museum employee with a bachelor’s degree in archeology, spent $7,000 to take college courses in personal income tax for his personal knowledge. His AGI is $42,250 and his taxable income is $33,800 ($42,250 - $5,150 standard deduction - $3,300 exemption). Refer to h/o 1 for single taxpayers and note that taxable income of $33,800 is in the 25% bracket. What educational incentives is he entitled to and how much tax savings will each incentive provide? See §§ 25A(c)(2)(B) and 222(d)(1) for the definitions of “qualified tuition.”

Option 1: LLC
The LLC is not applicable because the education is not to acquire of improve job skills.

Option 2: § 222
§ 222 applies because § 222(d)(1) refers to § 25A(f) to define qualified education. That section does not require that the education be related to job skills. $4,000 deduction x 25% bracket = $1,000 tax savings.

Option 2 is their only option.

Problem 2
Warren, an unmarried CPA who works for an accounting firm, paid $18,000 for law school tuition to improve his skills as an accountant. His employer reimbursed him for $13,250 of the tuition. Before these transactions, Warren’s AGI is $31,500 and he had no itemized deductions; he is in the 25% bracket. What alternatives are available and how should he report these transactions on his 2006 return to pay the lowest tax?

$5,250 of the $13,250 reimbursement is excluded under § 127 and $8,000 is included in income, which increases his AGI to $39,500.

He has $12,750 of qualified tuition expenses ($8,000 of the employer’s reimbursement included in income plus $4,750 of his own funds) eligible for §§ 222 or 25A.

Option 1: § 222
$4,000 adjustment in 25% bracket saves $1,000 of tax.

Option 2: LLC
$10,000 x 20% = $2,000 credit before phaseout. No phaseout because his $39,500 AGI is less than the $45,000 start of the phaseout.

Option 2 is better.
Problem 3
Emily and her husband Alan spent $8,000 and $4,800 respectively on law school tuition. Their AGI is $95,000 and they have no itemized deductions. They are in the 25% tax bracket. Determine if §§ 25A, 222 or a combination will provide the best tax result.

Option 1: Use LLC for both taxpayers

They had $12,800 of qualified expenditures, but the maximum is $10,000 per return.

$10,000 x 20% = $2,000 credit before phaseout.

phaseout: $110,000 ceiling - $95,000 AGI = $15,000 ÷ $20,000 = 75% remaining

$2,000 x 75% = $1,500 LLC

Option 2: Use § 222 for both: $4,000 deduction x 25% bracket = $1,000 of tax savings.

Option 3: Use § 222 for Alan and LLC for Emily

Alan’s § 222: He deducts $4,000 as an adjustment that saves $1,000 of tax

Emily’s LLC: She spent $8,000 x 20% = $1,600 LLC before phaseout

⇒ Alan’s $4,000 adjustment reduces their AGI to $91,000

phaseout: $110,000 - $91,000 AGI = $19,000 ÷ $20,000 = 95% remaining

$1,600 x 95% = $1,520 LLC

total savings: $2,520 ($1,000 for Alan’s § 222 deduction plus $1,520 for Emily’s LLC).

Option 4: Use § 222 for Emily and LLC for Alan

Emily’s § 222: She deducts $4,000 as an adjustment that saves $1,000 of tax

Alan’s LLC: He spent $4,800 x 20% = $960 LLC before phaseout

⇒ Emily’s $4,000 adjustment reduces their AGI to $91,000

phaseout: $110,000 - $91,000 AGI = $19,000 ÷ $20,000 = 95% remaining

$960 x 95% = $912 LLC

total savings: $1,912 ($1,000 for Emily’s § 222 deduction plus $912 for Alan’s LLC).

Option 3 is best.

It takes only $4,000 of educational expenses to get the maximum benefit for § 222, but it takes $10,000 of educational expenses to get the maximum benefit from the LLC ($10,000 x 20% = $2,000 maximum credit). Therefore the LLC should be used for the student who spent the most on tuition, as illustrated in this problem.
Problem 4
Same as problem 3, but Alan had never gone to college and he spent the $4,800 for tuition for his first year of college.

Option 1: Use LLC for Emily and Hope for Alan
As in problem 3, option 1, 75% of LLC and Hope credits remain after phaseout at $95,000 AGI.

   - Emily’s LLC: 8,000 x 20% = 1,600 LLC x 75% remaining = $1,200 LLC credit
   - Alan’s Hope: $4,800 of qualifying expenses
     100% of first $1,100 plus 50% of next $1,100 = $1,650 credit before phaseout
     $1,650 x 75% remaining = $1,238 of tax savings from Hope credit

   Total tax savings: $2,438

Option 2: Use § 222 for both taxpayers
same result as in problem 3, option 2: $1,000 tax saved

Option 3: Use § 222 for Alan and LLC for Emily
same result as in problem 3, option 3: $2,520 saved

Option 4: Use § 222 for Emily and Hope for Alan
   - Emily’s § 222: $4,000 adjustment x 25% bracket = $1,000 saved
   - Alan’s Hope: $1,650 credit before phaseout as determined in option 1
     Emily’s $4,000 adjustment reduces their AGI to $91,000
     phaseout: $110,000 - $91,000 AGI = $19,000 ÷ $20,000 = 95% remaining after phaseout
     $1,650 x 95% = $1,568.
     Total tax savings: $2,568

Option 4 is best.

Problem 5
The Baileys have an AGI of $147,000 and paid $20,000 in tuition for their son who is a college senior. What educational incentives are they entitled to and how much tax savings will result from each? They are in the 28% bracket.

Option 1: LLC: AGI exceeds $110,000; LLC is phased out.

Option 2: § 222: AGI exceeds $130,000, but not $160,000, so they can deduct $2,000 as an adjustment. This will save them $560 of tax.

Option 2 is their only option.
STUDENT LOAN INTEREST PROBLEMS

Phaseout Calculation

Use the following steps to calculate the interest deduction remaining after the phaseout:

1. subtract § 221 MAGI from the phaseout ceiling ($65,000 for single or $135,000 for married)
2. divide the result by the phaseout range ($15,000 single or $30,000 married);
3. multiply the percentage in step 2 by the interest paid ($2,500 maximum).

Example: Single taxpayer with § 221 MAGI of $54,000 paid $2,000 of qualified interest.

\[
\begin{align*}
&\quad \text{Result} = 65,000 - 54,000 = 11,000 \\
&\quad \text{Percentage} = \frac{11,000}{15,000} = 0.73 \ (73\%) \\
&\quad \text{Deductible} = 2,000 \times 0.73 = 1,460
\end{align*}
\]

PROBLEMS

Dad paid $3,000 of interest in 2006 on his daughter Julie’s student loan. He is not personally liable on the loan, which Julie obtained from the First Bank. Dad files a joint return with Mom, their AGI is $110,000, and they claim Julie as a dependent.

1. How much interest may Dad deduct in 2006? Read the first sentence in § 221(d)(1).

2. Same as (1), but Julie paid the interest and her AGI is $45,000. How much interest may she deduct? Read § 221(c).

For the rest of the problems, Julie paid the interest and could not be claimed as a dependent on her parents’ return.

3. Julie paid $3,000 of student loan interest; her AGI is $47,000. See § 221(b)(2).

4. Same as (3), but her AGI is $53,000.

5. Same as (4), but Julie borrowed the money from her uncle instead of a bank. Read the second sentence in the paragraph after § 221(d)(1)(C), but stop reading after “section 267(b)” and refer to § 267(b).

6. Same as (5), but instead of paying Uncle Fred $3,000 in cash for the interest, she gave him a painting worth $3,000 she bought for $2,200 two years ago. What are the tax consequences for Julie and Fred?
**STUDENT LOAN INTEREST SOLUTIONS**

**Problem 1**

Dad paid $3,000 of interest in 2006 on his daughter Julie’s student loan. He is not personally liable on the loan, which was secured from the First Bank. Dad files a joint return with Mom and their AGI is $110,000; they claim Julie as a dependent.

1. How much interest may Dad deduct in 2006? Read the introductory sentence in § 221(d)(1).

   none; he is not liable on the loan

2. Same as (1), but Julie paid the interest and her AGI is $45,000. How much interest may she deduct? Read § 221(c).

   none; dependents are not entitled to the deduction

For the rest of the problems, Julie paid the interest and was not claimed as a dependent on her parents’ return.

3. Julie paid $3,000 of student loan interest; her AGI is $47,000. See § 221(b)(2)

   $2,500, which is the maximum; her AGI does not exceed $50,000. It is deductible as an adjustment, § 62(a)(17), and entered in the § 221 & 222 column of the worksheet.

4. Same facts as (3), but Julie’s AGI is $53,000. See § 221(b)(2).

   maximum deduction is $2,500
   $65,000 ceiling minus $53,000 AGI = $12,000
   $12,000 ÷ $15,000 = 80%
   $2,500 maximum x 80% = $2,000 deductible

5. Same as (4), but Julie borrowed the money from her uncle instead of a bank. Read the second sentence in the paragraph after § 221(d)(1)(C), but stop reading after “section 267(b)” and refer to § 267(b).

   § 267(b)(1) refers to members of a family in § 267(c)(4) which doesn’t include uncles, so $2,000 of the interest is deductible

6. Same as (5), but instead of paying Uncle Fred $3,000 in cash for the interest, she gave him a painting worth $3,000 she bought for $2,200 two years ago. What are the tax consequences for Julie and Fred?

   Julie has an $800 LTCG on the sale of the painting and deducts $2,000 of loan interest
   Fred has $3,000 of interest income
DEPENDENT CARE CREDIT § 21

Code § 21 provides taxpayers a credit for expenses paid for the care of children under 13-years-old to enable parents to work. Up to $3,000 of qualified dependent care expense are eligible for the credit for one child and $6,000 for two or more children. Use the following steps to compute the credit:

1. Determine the eligible dependent care expenses, noting the limitations of §§ 21(c) and (d)(1).
2. Determine the applicable percentage by referring to the table below.
3. Multiply the eligible expenses by the applicable percentage to get the dependent care credit.

Example 1

Horwitz, a single taxpayer, has AGI of $29,000 and paid $4,000 to a day care center to care for his 3-year-old daughter. Only $3,000 of the expenses are eligible because he has one child under 13. The credit percentage is 28% based on his $29,000 AGI according to the table below. (Note that his AGI is not over $29,000.) The dependent care credit is $840 ($3,000 x 28%), which is deducted from his tax.

<table>
<thead>
<tr>
<th>AGI over but not over</th>
<th>%</th>
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<tbody>
<tr>
<td>0</td>
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<tr>
<td>15,000</td>
<td>.34</td>
</tr>
<tr>
<td>17,000</td>
<td>.33</td>
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<tr>
<td>21,000</td>
<td>.31</td>
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<td>23,000</td>
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<td>25,000</td>
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<td>29,000</td>
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<tr>
<td>39,000</td>
<td>.22</td>
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<tr>
<td>41,000</td>
<td>.21</td>
</tr>
<tr>
<td>43,000</td>
<td>.20</td>
</tr>
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</table>

The relationship between the § 21 credit and the § 129 exclusion

As explained in the last paragraph of casebook 454, two Code sections provide a tax benefit for dependent care expenses: the § 21 dependent care credit discussed above, and the § 129 exclusion for the dependent care assistance plans discussed in Chapter 11. Taxpayers can elect a combination of the two, but the expenses excluded under § 129 reduce the expenses eligible for the § 21 credit; see the last sentence of § 21(c).

Example

The Kents have two children under 13, spent $6,000 for child care, and have $79,000 of AGI. They excluded $5,000 under one of their employers § 129 plans (the statutory maximum), which leaves $1,000 of eligible expenses for the dependent care credit.
§ 21 dependent care credit or § 129 exclusion?

Taxpayers must elect to participate in a § 129 plan before the tax year begins so they should estimate whether the § 21 dependent care credit or the § 129 exclusion will give them a better tax result. The last two sentences on casebook page 454 ask whether taxpayers who spend $5,000 on child care expenses should choose $5,000 of taxable salary (and use the § 21 dependent care credit) or reduce their salary by $5,000 by using the § 129 exclusion.

The answer depends on the taxpayers’ AGI and tax bracket. Compare the tax saved using the dependent care credit to the tax saved using the $5,000 exclusion. The following example illustrates the computation.

Example 1

The Garrisons’ AGI is $100,000, earned equally between them; they are in the 25% tax bracket. They have a 9-year-old daughter and a 4-year-old son and paid $7,000 to a day care center to take care of the kids while they work. One of their employers offers a § 129 plan with a maximum contribution of $5,000.

**Option 1:** Designate the $5,000 maximum for the § 129 exclusion and use the $1,000 balance for the § 21 dependent care credit.

The $5,000 excluded saves them $1,250 in the 25% bracket. Their dependent care credit is $200 ($1,000 x 20%), making their total savings $1,450.

**Option 2:** Use $6,000 for the dependent care credit and do not exclude anything under § 129. The dependent care credit is **$1,200** ($6,000 of eligible expenses x 20%, based on their AGI). Option 1 saves them more tax than option 2.

Example 2

Same facts as example 1, but their AGI is $35,000 and they are in the 15% bracket, before considering the child care expenses.

**Option 1:** The $5,000 exclusion saves them $750 in tax in the 15% bracket. The exclusion reduces their AGI to $30,000. The $1,000 of remaining child care expenses are used for the dependent care credit. $1,000 x 27% (based on $30,000 of AGI) equals $270 tax saved. Total savings: **$1,020**.

**Option 2:** The § 21 credit saves them **$1,500** ($6,000 expenses x 25%, based on AGI of $35,000). In this example, option 2 provides the greater tax savings.

Generally, higher-bracket taxpayers benefit more from the exclusion and lower-bracket taxpayers benefit more from the credit.
DEPENDENT CARE PROBLEMS

Matt Baker earned $2,000 and his wife Marilyn earned $25,000 in 2006. They have two children, 14-year-old Laura and 9-year-old Robert. They paid $4,800 to a neighbor to watch their children during the year; $3,200 of the payments were for Robert and $1,600 were for Laura. They also spent $4,000 for overnight summer camp for Robert.

(a) How much is their dependent care credit? Note the limitation on eligible expenses in the last sentence of § 21(b)(2)((A) and § 21(d)(1)(B).

(b) Same facts, but Matt earned $50,000.

(c) Same as (b), but Laura was only 12-years-old.

(d) Same as (c), but they paid the friend $8,000 to watch the kids during the year.
Matt Baker earned $2,000 and his wife Marilyn earned $25,000 in 2006. They have two children, 14-year-old Laura and 9-year-old Robert. They paid $4,800 to a neighbor to watch their children during the year; $3,200 of the payments were for Robert and $1,600 were for Laura. They also spent $4,000 for overnight summer camp for Robert.

(a) How much is their dependent care credit? Note the limitation on eligible expenses in the last sentence of § 21(b)(2)((A) and § 21(d)(1)(B).

Summer camp expense does not qualify; only the $3,200 spent for Robert qualifies.
AGI is $27,000, so the percentage is 29%
$2,000 x 29% = $580 credit

(b) Same facts, but Matt earned $50,000.

AGI is now $75,000
They spent $3,200 for Robert, but the maximum eligible is $3,000 per child.
$3,000 x 20% = $600 credit

(c) Same as (b), but Laura was only 12-years-old.

AGI is $75,000
They spent $4,800 on the two kids, which is less than the $6,000 maximum eligible
$4,800 x 20% = $960 credit

(d) Same as (c), but they paid the friend $8,000 to watch the kids during the year.

AGI is $75,000
They spent $8,000 on the two kids, but $6,000 is the maximum eligible for two children.
6,000 x 20% = $1,200 credit
HOME OFFICE DEDUCTION § 280A

A taxpayer who uses a “home office” that meets the requirements of § 280A(c)(1) has two separate assets for tax purposes: the home office and a personal residence. If 25% of the area is used for the home office, then 25% is business property. Expenses incurred in owning and operating the home are allocated between the home office and the personal use. The expenses allocated to the home office are deductible to the extent provided in § 280A(c).

There are four categories of expenses incurred by a taxpayer operating a business from the home:

1. Business expenses unrelated to the home; these are fully deductible as adjustments if the taxpayer is self-employed or as 2% MIDs if the taxpayer is an employee.

2. Mortgage interest, real estate taxes and casualty losses are always deductible as itemized deductions, even if there is no business being carried on in the home. These are called always allowable (“a/a”) expenses. The a/a expenses allocated to the home office are deductible as adjustments if the taxpayer is self-employed, or as itemized deductions if the taxpayer is an employee. The expenses allocated to the personal use of the home are deductible as regular itemized deductions.

3. Maintenance and utility expenses (“operating expenses”) allocated to the home office are deductible to the extent the income attributable to the home office exceeds the category 1 and 2 expenses. Maintenance and utility expenses allocated to the personal residence are not deductible.

4. Depreciation allocated to the home office is deductible to the extent the income attributable to the business exceeds the first three categories of expense. Depreciation is not deductible for the personal portion of the home.

Carryover of Nondeductible Expenses

Home office expenses that are not deductible because they exceed the income from the business are carried forward to the next year. They will be deductible next year or in future years if there is sufficient income in those years to absorb them.

The example on the next page illustrates the computation.
Example

Brown, a self-employed artist, operates out of an office/studio in his home that occupies 25% of the area in the home. The home is the principal place of business for his art activities. He has $26,500 of gross income from art sales and the following expenses: $21,000 of direct business expenses (supplies, materials, telephone, etc.), $8,000 of mortgage interest and real estate taxes, $4,000 of operating expenses (utilities, insurance, maintenance expenses, etc.), and $12,000 of depreciation. Brown’s deductions are determined as follows:

<table>
<thead>
<tr>
<th></th>
<th>25%</th>
<th>75%</th>
</tr>
</thead>
<tbody>
<tr>
<td>business income</td>
<td>$26,500</td>
<td></td>
</tr>
<tr>
<td>minus direct business expenses</td>
<td>-21,000</td>
<td></td>
</tr>
<tr>
<td>minus “a/a” expenses ($8,000 x 25% = $2,000 business)</td>
<td>-2,000</td>
<td>$6,000 itemized deductions</td>
</tr>
<tr>
<td>equals expenses remaining deductible</td>
<td>3,500</td>
<td></td>
</tr>
<tr>
<td>minus operating expenses ($4,000 x 25% = $1,000 business)</td>
<td>-1,000</td>
<td>$3,000 nondeductible</td>
</tr>
<tr>
<td>expenses remaining deductible</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>minus depreciation ($12,000 x 25% = $3,000 business)</td>
<td>-2,500</td>
<td>$9,000 nondeductible</td>
</tr>
<tr>
<td>equals business income or loss</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

Only $2,500 of the $3,000 depreciation expense allocated to the home office is deductible. The $500 remaining depreciation allocated to the home office is carried forward to next year.

The $21,000 of direct business expenses and the $5,500 of home expenses allocated to the home office are deductible as adjustments under § 62(a)(1) because Brown is not an employee. $6,000 of “a/a” expenses allocated to the personal use are deductible as itemized deductions. $9,000 of operating and deprecation expenses allocated to the personal use are nondeductible personal expenses.

Notes

1. If Brown had been an employee, the $21,000 of direct business expenses and the $3,500 of operating and depreciation expenses would have been deductible as 2% MIDs. The $2,000 of always allowable expenses would have been itemized deductions.

2. If Brown’s business income was only $4,000, all $21,000 of the direct business expenses and the $2,000 of “a/a” expenses allocated to the business use would still be deductible as adjustments.

Home Offices and the § 121 Exclusion

Assume Brown purchased the home four years ago for $220,000, deducted a total of $10,000 of depreciation, and sold the home for $300,000. The basis of the home is $210,000, after subtracting the depreciation deductions, so he has a $90,000 gain.

As with other depreciable real property, the $10,000 of gain attributable to depreciation is recaptured as RE LTCG and entered in the RE LTCG column of the worksheet. The $80,000 balance of the gain is excluded under § 121.
Solution to Casebook Home Office Problem 2, p. 477

<table>
<thead>
<tr>
<th></th>
<th>10%</th>
<th>90%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>gross income</strong></td>
<td>$4,000</td>
<td></td>
</tr>
<tr>
<td><strong>minus:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>direct business expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>supplies</td>
<td>$250</td>
<td></td>
</tr>
<tr>
<td>advertising</td>
<td>750</td>
<td></td>
</tr>
<tr>
<td>office phone service</td>
<td>900</td>
<td></td>
</tr>
<tr>
<td>total business expenses</td>
<td>1,900</td>
<td>-1,900</td>
</tr>
<tr>
<td>always allowable (a/a)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>real estate taxes: 3,000 x 10%</td>
<td>300</td>
<td>$2,700</td>
</tr>
<tr>
<td>mortgage interest: 10,000 x 10%</td>
<td>1,000</td>
<td>9,000 itemized</td>
</tr>
<tr>
<td>total a/a expenses</td>
<td>1,300</td>
<td>-1,300</td>
</tr>
<tr>
<td>expenses remaining deductible</td>
<td>800</td>
<td></td>
</tr>
<tr>
<td><strong>minus:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>operating expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$600 yard expense (not considered business)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>insurance: $2,000 x 10%</td>
<td>-200</td>
<td>1,800 nondeductible</td>
</tr>
<tr>
<td>utilities: $2,500 x 10%</td>
<td>-250</td>
<td>2,250 nondeductible</td>
</tr>
<tr>
<td>expenses remaining deductible</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>minus depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$7,500 x 10% = $750 (only $350 deductible)</td>
<td>-350</td>
<td>6,750 nondeductible</td>
</tr>
<tr>
<td>business income or loss</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

$350 of depreciation is deductible and the remaining $400 is carried over to next year.

The direct business expenses and the home expenses allocated to the home office are deductible as adjustments.

**Additional Question**

What if her business expenses had been $3,300?

The full amount of the a/a and business expenses would have been deductible as adjustments. All operating and depreciation expenses would be carried over to next year.
**Background**

Before Congress enacted at risk rules, a taxpayer was permitted to deduct losses from a business activity to the extent of her basis in the activity. For example, Holmes purchased a limited partnership interest in 1971 for $100,000, paying $10,000 in cash and borrowing $90,000 on a nonrecourse note; her basis is $100,000. Her share of the partnership loss was $110,000 in 1971 and she deducted $100,000 of it (up to the amount of her basis). If she were in the 70% tax bracket, the $100,000 deduction saved her $70,000 of tax, although she risked only $10,000 of her personal assets in the activity.

Section 465 was intended to eliminate such favorable tax consequences. The at risk rules provide that losses from a business activity are deductible only to the extent the taxpayer has assets at risk. If § 465 had been in effect, Holmes could have deducted only the $10,000 she had at risk.

**Determining the Amount At Risk**

A taxpayer must keep track of the amount remaining at risk in an activity and his deductions from the activity cannot exceed the amount remaining at risk. The amount at risk is increased by:

- (a) cash or property contributed by the taxpayer;
- (b) debt on which the taxpayer is personally liable (recourse debt);
- (c) qualified nonrecourse financing, § 165(b)(6), as defined on casebook p. 1035;
- (d) the taxpayer’s share of income from the activity;
- (e) gain on the sale of the activity.

The amount at risk is decreased by:

- (a) withdrawals or distributions of cash or property from the partnership;
- (b) the taxpayer’s share of the activity’s losses.

**A Partner’s Share of Income**

Note that a partner’s share of partnership income increases the partner’s amount at risk. In year 3 on the next page, for example, Eric’s share of the partnership’s income is $2,000. Why did it increase his amount at risk by $2,000?

A partnership is a “conduit” for tax purposes. A partnership files an information tax return with the IRS, but each partner reports his or her share of the partnership’s income or loss on their individual tax returns. In year 3, Eric included his $2,000 share of partnership income in gross income and paid tax on it. However, he did not receive any cash from the partnership. For tax purposes, it is considered as if the partnership distributed $2,000 of cash to Eric, which he reported as income, and then Eric contributed it back to the partnership. The $2,000 “contribution” to the partnership increases his amount at risk by $2,000.
**Eric’s Investment**

Refer to the example that begins in the second full paragraph of casebook page 1036. Although Eric purchased property in the example, we will assume he purchased an interest in a limited partnership. (The rules are the same.)

**Year 1**

Eric paid $100,000 for the partnership interest, investing $10,000 cash and borrowing $90,000 on a nonrecourse loan. His amount at risk begins at $10,000. He has more than $5,000 at risk so he can deduct the full $5,000 loss, which reduces the balance at risk to $5,000. You will learn in the second half of this chapter that this is a passive activity. Eric enters the $5,000 loss in the passive column of the tax computation worksheet.

**Year 2**

The $5,000 payment on the nonrecourse debt came from partnership funds, not from Eric personally. This transaction does not affect his amount at risk. He withdrew $2,000 of cash from the activity, which reduces his at risk balance to $3,000. He can deduct only $3,000 of the $8,000 loss because that is the amount he has left at risk. He enters the $3,000 loss in the passive column of the worksheet. The loss reduces his at risk balance to zero. The $5,000 balance of the loss is carried over to next year and will be deductible in a later year if his amount at risk is increased by additional contributions or partnership profits.

That is all of the Eric example assigned on the syllabus. We will continue with Eric using the following additional transactions.

**Year 3**

Eric’s share of the partnership income for year 3 is $2,000, which increases his amount at risk to $2,000. He is now permitted to deduct $2,000 of the loss being carried over that will offset the $2,000 of income for the year. Nothing is entered in the passive column for this year.

**Year 4**

His share of the partnership income for the year is $7,000 and the partnership distributes $1,500 of cash to him. The $7,000 income increases his amount at risk to $7,000 and the $1,500 cash distribution reduces it to $5,500. He can now deduct the $3,000 of loss being carried over from prior years, which will reduce the amount remaining at risk to $2,500.

In year 4, he enters $4,000 of income in the passive column ($7,000 of income from year 4 minus $3,000 of carryover loss he can deduct). At the end of year 4, he has $2,500 remaining at risk and all losses being carried over have been deducted.
Year 5

His share of the loss from the activity is $6,500. He has $2,500 left at risk so he deducts $2,500, which reduces his at risk balance to zero. The $4,000 balance of the loss is carried over to future years. He enters the $2,500 loss in the passive column.

<table>
<thead>
<tr>
<th>Year</th>
<th>Transaction</th>
<th>Balance At Risk</th>
<th>Loss Carried Over</th>
<th>Entry in Passive Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>90,000 nonrecourse debt 10,000 cash contribution 5,000 loss deducted balance at risk</td>
<td>0 10,000 - 5,000 5,000</td>
<td>0</td>
<td>(5,000)</td>
</tr>
<tr>
<td>2</td>
<td>2,000 withdrawn balance at risk 8,000 loss; 3,000 deducted balance at risk</td>
<td>- 2,000 3,000 - 3,000 0</td>
<td>5,000</td>
<td>(3,000)</td>
</tr>
<tr>
<td>3</td>
<td>2,000 income balance at risk deduct 2,000 of carryover loss balance at risk</td>
<td>+ 2,000 2,000 - 2,000 0</td>
<td>3,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td>4</td>
<td>7,000 income 1,500 withdrawn balance at risk deduct 3,000 of carryover loss balance at risk</td>
<td>+ 7,000 - 1,500 5,500 - 3,000 2,500</td>
<td>7,000</td>
<td>(3,000)</td>
</tr>
<tr>
<td>5</td>
<td>6,500 loss; 2,500 deducted balance at risk</td>
<td>- 2,500 0</td>
<td>4,000</td>
<td>(2,500)</td>
</tr>
</tbody>
</table>
### Solution to At Risk Problem, Casebook p. 1031

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Balance of Amount At Risk</th>
<th>Loss Carried Over</th>
<th>Entry in Passive Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) 10,000 investment</td>
<td>10,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) 5,000 loss</td>
<td>5,000</td>
<td></td>
<td>(5,000)</td>
</tr>
<tr>
<td>(e) 12,000 loss <strong>(per syllabus)</strong></td>
<td>0</td>
<td>7,000</td>
<td>(5,000)</td>
</tr>
<tr>
<td>(f) 5,000 investment dedent 5,000 of carryover loss</td>
<td>5,000</td>
<td>2,000</td>
<td>(5,000)</td>
</tr>
<tr>
<td>(g) 3,000 income deduct 2,000 of carryover loss</td>
<td>3,000</td>
<td>1,000</td>
<td>(2,000)</td>
</tr>
</tbody>
</table>

#### Reconciliation

**Amounts at risk:**
- (a) 10,000
- (f) 5,000
- Total 15,000

**Activity Income and Losses**
- (d) (5,000)
- (e) (12,000)
- (g) 3,000
- Total (14,000)

**Income and Losses Entered in Passive Column:**
- (d) (5,000)
- (e) (5,000)
- (f) (5,000)
- (g) 3,000
- (g) (2,000)
- Total (14,000)

**Summary:** He invested $15,000 and deducted $14,000 of losses, leaving $1,000 still at risk.
A. **Introduction**

A “tax shelter” is a business activity, usually organized as a limited partnership, in which the promoters structure the activities to incur significant tax losses in the early years of operation. Partnerships do not pay tax; each partner reports his or her share of the partnership’s gain or loss on their individual return. Each tax shelter partner deducted his share of the partnership’s losses on their individual returns which offset other sources of income, such as salaries, fees, interest and dividends. The partnership losses “sheltered” the regular income from tax. The limited partners did not participate in the business; they were merely investors and the activities were “passive” activities.

Section 469 was enacted to prevent taxpayers from deducting passive losses from non-passive income, with a few exceptions we will study. Passive losses are deductible only from passive income. An investor may no longer deduct a $1 million tax shelter loss from $1 million of fee income.

1. **Active Activities**

A trade or business activity is an active activity if the taxpayer “materially participates” in the activity on a regular, continuous and substantial basis. Income from active activities is entered in the ordinary income column of the worksheet and losses are entered in the regular adjustment column. Dr. Fluxgold earned $300,000 from her medical practice. She also owns and operates a medical supply business that lost $20,000 during the year. She materially participates in the supply business so it is an active activity. The loss is entered in the adjustment column and will be deducted from her gross income without limitation.

2. **Passive Activities**

A passive activity is a trade or business that the taxpayer does not materially participate in. Assume Fluxgold’s family operated the medical supply business and she was a partner but did not participate in the business. Her share of the gain or loss is passive and is entered in the passive column. The supply business is an active activity for the family members who work in the business. For our purposes, all losses from limited partnerships will be considered passive activity losses.

3. **Rental Activities**

Rental activities of personal or real property are considered passive activities no matter how much the taxpayer participated in the activity. However, § 469(c)(7) provides an exception for “real estate professionals” who spend more than one-half of their time participating in real estate activities and at least 750 hours per year. These taxpayers report gains and losses from their real estate activities as active gains or losses. None of the taxpayers in the course will be real estate professionals.
B. Tax Treatment of Passive Losses

1. Apply the At Risk Rules First

A taxpayer’s share of the income or loss from a passive activity is entered in the passive column of the worksheet. However, a taxpayer may not deduct more than she has at risk in the activity. If the taxpayer has a loss from an activity, determine how much remains at risk. Enter the lesser of the loss for the year or the amount left at risk in the passive column. If a taxpayer has a $20,000 loss but only $9,000 left at risk, she enters $9,000 of loss in the passive column. If the taxpayer has income from the activity in a year, she enters the full amount of income in the passive column.

2. Enter passive gains and losses in the passive column of the worksheet.

Enter the passive gains and losses from each activity in the passive column, then total the column. If the total is a gain, enter the gain in the ordinary income column. If the total is a loss, the taxpayer may not deduct any of the loss unless the real estate exception applies. (A taxpayer may also deduct passive losses related to a passive activity in the year she completely disposes of the activity, but that will not happen in this course.)

3. Real Estate Exception

A taxpayer may deduct up to $25,000 of losses from passive real estate activities in which she “actively” participates. Active participation for the real estate exception requires less personal involvement than the “material” participation required for an active business activity. Merely hiring a building manager is sufficient for active participation. If the taxpayer meets the active participation requirement, the activity is a “qualifying real estate” activity.

4. MAGI and the Phaseout of the Real Estate Exception

Modified adjusted gross income (MAGI) for purposes of deducting passive losses is gross income minus all adjustments except the adjustments for §221 student loan interest and §222 education expenses. This will be explained further in the following handout.

The $25,000 real estate exception is phased out by 50% of the amount that MAGI exceeds $100,000 and is fully phased out at $150,000 of MAGI. If MAGI is within the phaseout range, calculate the amount of exception remaining after phaseout as follows. Subtract the MAGI from $150,000 and divide the result by two. If Rosenberg’s MAGI is $122,000, he has $14,000 of real estate exception left, calculated as follows: $150,000 - $122,000 MAGI = $28,000 ÷ 2 = $14,000.

Example 1

Cohen paid $42,000 for an investment in a qualifying real estate activity three years ago and had $30,000 remaining at risk. In the current year, his salary is $119,000, he paid $3,000 of alimony, and his share of the loss from the activity is $36,000.

He enters $30,000 of the loss (the lesser of the loss or the amount remaining at risk) in the passive column of the worksheet. The $6,000 balance of the loss is carried forward to next year under the at risk rules. This is his only passive activity for the year so the passive column total is $30,000 loss.

His MAGI is $116,000 ($119,000 salary minus $3,000 alimony). Subtract $116,000 from $150,000 and divide the $34,000 result by 2 to get $17,000 of RE passive loss exception remaining. The $13,000 balance of the loss in the passive column is carried over and entered in the passive column of next year’s worksheet. His §221 MAGI is $99,000 ($116,000 MAGI minus $17,000 of deductible passive loss).
5. **Complete Disposition of a Passive Activity**

In the year the taxpayer completely disposes of an interest in a passive activity to an unrelated party, all current and carryover losses are deductible to the extent of the remaining amount at risk. If Cohen’s MAGI had been $175,000 in example 1, none of the losses would have been deductible under the real estate exception. However if he had completely disposed of the activity in the year, he could have deducted $30,000 of the loss; he cannot deduct the $6,000 of loss for which he was not at risk. Losses disallowed under the *at risk* rules disappear when the activity is disposed of. You will not have a complete disposition on the exam.


**Step 1:** Enter the income or loss from each activity in the passive column

Analyze each passive activity separately. If the activity has income for the year, enter the income in the passive column of the worksheet. If the activity has a loss, enter the lesser of the loss for the year or the amount left at risk in the passive column. (Make sure to put parentheses around losses entered in the worksheet.) Write “RE” next to the income and losses from qualified real estate activities (activities in which the taxpayer actively participates) to identify the gains and losses that will qualify for the real estate exception.

**Step 2:** Determine the amount of qualified RE loss

Total the column. If the total is a **gain**, enter it in the ordinary income column of the worksheet.

If the total is a **loss**, add the income and losses from all of the qualified real estate activities (the ones marked “RE”) to determine the net income or loss from these activities. For example, if there is a $12,000 loss from qualified real estate activity “A” and $4,000 of income from qualified real estate activity “B,” the net loss from qualified real estate activities is $8,000.

**Step 3:** Determine the amount of real estate exception available

If MAGI exceeds $150,000, none of the qualified real estate loss is deductible. If MAGI is less than $100,000, up to $25,000 of real estate loss is deductible. If MAGI is between $100,000 and $150,000, subtract MAGI from $150,000 and divide the result by 2. The result is the amount of real estate exception available.

**Step 4:** Deduct the lesser of the following:

(a) the qualifying real estate loss determined in step 2;
(b) the real estate exception remaining determined in step 3, or
(c) the total of the passive column

The amount deductible is entered in the regular adjustment column of the worksheet.
Example 2

Rubin had (A) $7,000 loss from a movie activity with $3,000 remaining at risk and (B) $9,000 loss from a qualifying real estate activity with $15,000 at risk. Her MAGI is $122,000.

Step 1. Rubin’s passive column total is a $12,000 loss:

<table>
<thead>
<tr>
<th>Passive Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) (3,000)</td>
</tr>
<tr>
<td>(B) (9,000) RE</td>
</tr>
<tr>
<td>(12,000)</td>
</tr>
</tbody>
</table>

Step 2. She has $9,000 of qualifying real estate loss.

Step 3. $14,000 of RE exception is available ($150,000 - $122,000 = $28,000 ÷ 2).

Step 4: $9,000 of real estate loss is entered in the adjustment column. $9,000 is the lesser of: (a) $9,000 qualifying loss, (b) $14,000 of exception remaining and (c) $12,000 column total.

$4,000 of the movie loss was not deductible under the at risk rules and cannot be entered in the passive column until Rubin has more at risk in this activity. $3,000 of the movie loss was not deductible under the passive loss rules and is carried over. It will be entered in next year’s passive column.

Example 3

Kennelly’s MAGI is $138,000 and he has the following income and loss for the year: (A) $5,000 income from a nonqualifying activity with $4,000 at risk; (B) $15,000 loss from a qualifying real estate activity with $13,000 at risk; (C) $3,000 income from a limited partnership with $4,000 at risk.

Step 1. Kennelly’s passive column looks like this:

<table>
<thead>
<tr>
<th>Passive Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) 5,000</td>
</tr>
<tr>
<td>(B) (13,000) RE</td>
</tr>
<tr>
<td>(C) 3,000</td>
</tr>
<tr>
<td>(5,000)</td>
</tr>
</tbody>
</table>

Step 2: Kennelly has $13,000 of qualifying RE loss.

Step 3: $6,000 of real estate exception remains ($150,000 - $138,000 MAGI = $12,000 ÷ 2).

Step 4: He enters $5,000 of passive loss in the regular adjustment column of the worksheet (the lesser of the $13,000 qualifying loss, the $6,000 RE exception remaining and the $5,000 column total). The remaining $8,000 of the qualifying RE loss was subtracted from the gains of the other two activities. The $5,000 deductible loss is entered in the adjustment column.
PASSIVE ACTIVITY LOSS PROBLEMS

Determine the MAGI for each of the following taxpayers after deducting passive losses, if any. When the problem indicates the gain or loss is from a “qualifying” RE activity, that means the taxpayer actively participates in the activity and losses will qualify for the RE exception. If the gain or loss is from a RE activity that does not state “qualifying,” the taxpayer does not actively participate in the activity.

**Problem 1**
Schwartz had a $130,000 salary and the following losses:

- (A) $12,000 loss from a RE activity with $17,000 at risk
- (B) $15,000 loss from a qualifying RE activity with $13,000 at risk

**Problem 2**
Same as (1), but her salary was $120,000.

**Problem 3**
Same as (1), but she also paid $5,000 in alimony to her former husband.

**Problem 4**
Armstrong had a $132,000 salary and the following income and losses:

- (A) $15,000 loss from a limited partnership with $18,000 at risk
- (B) $2,000 income from qualifying RE activity A with $1,000 at risk
- (C) $12,000 loss from qualifying RE activity B with $10,000 at risk

**Problem 5**
Lapointe had a $128,000 salary and the following income and losses:

- (A) $19,000 loss from a qualifying RE activity with $16,000 at risk
- (B) $7,000 income from a RE activity with $5,000 at risk

**Problem 6**
Mondi had a $122,000 salary and the following income:

- (A) $12,000 income from a qualifying RE activity with $15,000 at risk
- (B) $20,000 income from a limited partnership with $12,000 at risk

**Problem 7**
Desai had a $90,000 salary and the following income and losses:

- (A) $13,000 loss from a movie activity with $11,000 at risk
- (B) $6,000 income from a RE activity with $5,000 at risk
- (C) $13,000 loss from a qualifying RE activity with $16,000 at risk
Problem 8

Wurful purchased a condominium for investment purposes on January 4, 2006 and actively participates in management. She paid $10,000 cash and obtained an $80,000 nonrecourse loan. In January she spent $10,000 to remodel the kitchen. She received $6,000 of rent and spent $4,500 for the following out-of-pocket expenses: $1,000 for condo assessments; $1,500 for real estate taxes; and $2,000 for mortgage interest. Her MAGI is $146,000.

(a) How much is her 2006 depreciation deduction?

(b) What is her gain or loss from this activity in 2006? (Subtract all expenses, including depreciation, from income.) If she has a loss, how much can she deduct, assuming this is her only passive activity for the year.

On January 15, 2007, she sold the condo for $108,000 and paid a $5,000 broker’s commission. The mortgage balance is still $80,000 and she did not have any rent income or expenses in 2007.

(c) How much depreciation can she deduct in 2007?

(d) What is her gain or loss on the sale and how should it be characterized? (Review the characterization of gains from the sale of depreciable real property on the depreciation handout.)

(e) How much is her economic gain on the purchase and sale (ignore the rent income)?

(f) If the economic gain differs from the tax gain, what accounts for the difference?
PASSIVE ACTIVITY LOSS SOLUTIONS

Determine the § 221 MAGI for each of the following taxpayers. If the taxpayer actively participates in a real estate activity, it will be identified as a qualifying RE activity.

<table>
<thead>
<tr>
<th>Problem 1</th>
<th>Schwartz had a $130,000 salary and the following losses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A)</td>
<td>$12,000 loss from a RE activity with $17,000 at risk</td>
</tr>
<tr>
<td>(B)</td>
<td>$15,000 loss from a qualifying RE activity with $13,000 at risk</td>
</tr>
</tbody>
</table>

Passive Column

| (A) | (12,000) |
| (B) | (13,000) RE |
| (25,000) |

$150,000 - $130,000 MAGI = $20,000 ÷ 2 = $10,000 of exception available; 
deduct $10,000 of qualifying loss (the lesser of the loss, column total or exception available); 
$130,000 MAGI - $10,000 passive loss deduction = $120,000 § 221 MAGI.

<table>
<thead>
<tr>
<th>Problem 2</th>
<th>Same as (1), but her salary was $120,000.</th>
</tr>
</thead>
</table>

$150,000 - $120,000 MAGI = $30,000 ÷ 2 = $15,000 of exception available; 
deduct $13,000 of qualifying loss (lesser of $13,000, $15,000 or $25,000); 
$120,000 MAGI - $13,000 passive loss deduction = $107,000 § 221 MAGI.

<table>
<thead>
<tr>
<th>Problem 3</th>
<th>Same as (1), but she also paid $5,000 in alimony to her former husband.</th>
</tr>
</thead>
</table>

$130,000 salary - $5,000 alimony = $125,000 MAGI; 
$150,000 - $125,000 = $25,000 ÷ 2 = $12,500 of exception available; 
deduct $12,500 of qualifying loss (lesser of $13,000, $12,500 or $25,000); 
$125,000 MAGI - $12,500 passive loss deduction = $112,500 § 221 MAGI.

<table>
<thead>
<tr>
<th>Problem 4</th>
<th>Armstrong had a $132,000 salary and the following income and losses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A)</td>
<td>$15,000 loss from a limited partnership with $18,000 at risk</td>
</tr>
<tr>
<td>(B)</td>
<td>$2,000 income from qualifying RE activity A with $1,000 at risk</td>
</tr>
<tr>
<td>(C)</td>
<td>$12,000 loss from qualifying RE activity B with $10,000 at risk</td>
</tr>
</tbody>
</table>

Passive Column

| (A) | (15,000) |
| (B) | 2,000 RE |
| (C) | (10,000) RE |
| (23,000) |

$150,000 - $132,000 MAGI = $18,000 ÷ 2 = $9,000 of exception available; 
$10,000 loss minus $2,000 gain = $8,000 loss from qualifying activities; 
deduct $8,000 (lesser of $8,000, $9,000 or $23,000); 
$132,000 MAGI - $8,000 passive loss deduction = $124,000 § 221 MAGI.
**Problem 5**  Lapointe had a $128,000 salary and the following income and losses:

(A) $19,000 loss from a qualifying RE activity with $16,000 at risk  
(B) $7,000 income from a RE activity with $5,000 at risk

<table>
<thead>
<tr>
<th>Passive Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) (16,000)</td>
</tr>
<tr>
<td>(B) 7,000</td>
</tr>
<tr>
<td>(9,000)</td>
</tr>
</tbody>
</table>

$150,000 - $128,000 MAGI = $22,000 ÷ 2 = $11,000 of exception available;  
deduct $9,000 of qualifying loss (lesser of $16,000, $11,000 or $9,000);  
$128,000 MAGI - $9,000 passive loss deduction = \$119,000 \$ 221 MAGI.

**Problem 6**  Mondi had a $122,000 salary and the following income:

(A) $12,000 income from a qualifying RE activity with $15,000 at risk  
(B) $20,000 income from a limited partnership with $12,000 at risk

<table>
<thead>
<tr>
<th>Passive Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) 12,000</td>
</tr>
<tr>
<td>(B) 20,000</td>
</tr>
<tr>
<td>32,000</td>
</tr>
</tbody>
</table>

$122,000 MAGI + $32,000 passive gain = \$154,000 \$ 221 MAGI.

**Problem 7**  Desai had $90,000 salary and the following income and losses:

(A) $13,000 loss from a movie activity with $11,000 at risk  
(B) $6,000 income from a RE activity with $5,000 at risk  
(C) $13,000 loss from a qualifying RE activity with $16,000 at risk

<table>
<thead>
<tr>
<th>Passive Column</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) (11,000)</td>
</tr>
<tr>
<td>(B) 6,000</td>
</tr>
<tr>
<td>(C) (13,000)</td>
</tr>
<tr>
<td>(18,000)</td>
</tr>
</tbody>
</table>

There is $13,000 of qualifying RE loss;  
$25,000 of exception is available;  
deduct $13,000 of qualifying loss (lesser of $25,000, $18,000 or $13,000);  
$90,000 MAGI - $13,000 passive loss deduction = \$77,000 \$ 221 MAGI.
Problem 8
Wurful purchased a condominium for investment purposes on January 4, 2006 and actively participates in management. She paid $10,000 cash and obtained an $80,000 nonrecourse loan. In January she spent $10,000 to remodel the kitchen. She received $6,000 of rent and spent $4,500 for the following out-of-pocket expenses: $1,000 for condo assessments; $1,500 for real estate taxes; and $2,000 for mortgage interest. Her MAGI is $146,000.

(a) How much is her 2006 depreciation deduction?

$3,485 ($100,000 basis x .03485) from Table 1 on the depreciation handout.

(b) What is her gain or loss from this activity in 2006? (Subtract all expenses, including depreciation, from income.) If she has a loss, how much can she deduct if this is her only passive activity for the year.

rental $6,000
minus out of pocket expenses:
    assessments 1,000
    real estate taxes 1,500
    mortgage interest 2,000
    total out of pocket expenses 4,500
equals cash flow 1,500
minus depreciation expense 3,485
passive loss for tax purposes ($1,985)

She actively participated in the activity so it is a qualified real estate loss and $1,985 of loss was entered in the passive loss column. This is the only passive activity so the column total is $1,985 loss. There is $2,000 of RE exception left ($150,000 - $146,000 MAGI = $4,000 ÷ 2 = $2,000), so the entire $1,985 loss is deductible as an adjustment.

On January 15, 2007, she sold the condo for $108,000 and paid a $5,000 broker’s commission. The balance of the mortgage loan is still $80,000. She did not have any rent income or expenses in 2007.

(c) How much depreciation can she deduct in 2007?

$152 ($100,000 x .03636 = $3,636 ÷ 12 = $303/month ÷ 2 (½ month for the month of disposition)).

(d) What is her gain or loss on the sale and how should it be characterized?

The adjusted basis of the condo at the time of sale is $96,363 ($100,000 cost - $3,485 of 2006 depreciation and $152 of 2007 depreciation.

amount realized $103,000 ($23,000 cash + $80,000 paid to bank - $5,000 commission)
minus adjusted basis 96,363
equals tax gain on the sale $6,637

$3,637 of the gain is RE LTCG (the depreciation deducted) and the $3,000 balance is LTCG.

(e) How much is her economic gain on the purchase and sale (ignore the rent income)?

She invested $20,000 in cash and received $23,000 on the sale, giving her a $3,000 gain.

(f) If the economic gain differs from the tax gain, what accounts for the difference?

The $6,637 tax gain includes the $3,000 economic gain plus $3,637 of depreciation she deducted which reduced her taxable income in the years of the deductions.
DETERMINING AGI

The deductions for student loan interest, deductible tuition, and real estate passive losses are all adjustments, see §§ 62(a)(1), (17) and (18). Their respective phaseouts are as follows.

Phaseouts

Qualified RE passive losses: phased out between $100,000 - $150,000 of MAGI;

§ 221 student loan interest: phased out between MAGI of $50,000 - $65,000 on a single return and $105,000 - $135,000 on a joint return;

§ 222 tuition deduction: AGI cannot exceed $65,000 or $130,000 on a joint return for the $4,000 deduction and $80,000 or $160,000 on a joint return for the $2,000 deduction.

Deduction Order

Each deduction depends on AGI so how do we know what the AGI is for each deduction? Each Code section defines AGI is for purposes of that deduction.

(a) **Passive Losses:** Code § 469(i)(3)(F)(iii) provides that AGI for purposes of the passive loss deduction is determined “without regard to” (before deducting) the § 221 interest and § 222 tuition deductions.

(b) **Student Loan Interest:** Code § 221(b)(2)(C)(i) provides that MAGI is determined “after application of” (after deducting) § 469 passive losses.

(c) **§ 222 Tuition Deduction:** Code § 222(b)(2)(C)(ii) provides that AGI is determined after application of the § 221 student interest and § 469 passive losses deductions.

As a result, adjustments are deducted in the following order:

1. Adjustments not listed below, such as alimony and business expenses (“regular adjustments”). These will be in the “regular” adjustment column of the worksheet.

2. § 469 real estate passive losses

3. § 221 student loan interest

4. § 222 tuition

The tax formula is now:

gross income minus regular adjustments equals § 469 MAGI (for deducting passive losses) minus deductible passive losses equals § 221 MAGI (for deducting student loan interest) minus deductible student loan interest equals § 222 MAGI (for deducting tuition) minus the tuition deduction equals AGI
AGI PROBLEMS

Determine the tax for the following taxpayers, using the following steps:

1. subtract adjustments in the correct order to arrive at AGI;
2. subtract the standard deduction and exemptions (from h/o 1) to arrive at taxable income;
3. use the tax calculator to determine the tax.

Problem 1

Samantha and Tom they have one child under 17 and the following 2006 transactions:

(a) $127,000 salary income
(b) Tom paid $2,000 of student loan interest
(c) paid $10,000 for law school tuition
(d) $15,000 loss from a qualifying real estate partnership with $9,500 at risk

Problem 2

Bill and Jill have three children under 17 and had the following 2006 transactions:

(a) $165,000 of salary income
(b) paid $30,000 of alimony
(c) $25,000 of passive loss in a qualifying real estate activity with $2,500 at risk
(d) Bill paid $2,000 and Jill paid $1,000 of student loan interest
(e) paid $10,000 for qualified tuition
AGI SOLUTIONS

Problem 1

salaries .............................. $127,000
no regular adjustments ...................... - 0
equals § 469 MAGI* ...................... 127,000
subtract $9,500 remaining at risk .......... - 9,500
equals § 221 MAGI ......................... 117,500
minus student loan interest** .......... 1,167
equals § 222 MAGI ......................... 116,333
minus tuition deduction (AGI < $130,000) .... - 4,000
equals AGI ................................ 112,333
minus standard deduction ................. - 10,300
minus 3 exemptions @ $3,300 ............ - 9,900
equals taxable income ..................... $92,133
tax = $16,148 before credits

* passive loss exception available
  phaseout: $150,000 - $127,000 = $23,000 ÷ 2 = $11,500 RE exception left

** student loan interest deduction
  $135,000 phaseout ceiling - $117,500 MAGI for § 221 purposes = $17,500
  $17,500 ÷ $30,000 = .5833 (58.33%) deduction remaining
  $2,000 interest before phaseout x .5833 = $1,167 interest deduction

Problem 2

salaries .............................. $165,000
minus regular adjustments (alimony) .......... - 30,000
equals § 469 MAGI ......................... 135,000
minus RE passive loss deduction ($7,500 exception left) .... - 2,500
equals § 221 MAGI ......................... 132,500
minus student loan interest* ............. - 208
equals § 222 MAGI ......................... 132,292
minus tuition deduction (AGI > 130,000, < $160,000) ...... - 2,000
equals AGI ................................ 130,292
minus standard deduction .................. - 10,300
minus 5 exemptions @ $3,300 ............. - 16,500
equals taxable income ...................... $103,492
tax = $18,988 before credits

* student loan interest deduction
  $135,000 phaseout ceiling - $132,500 MAGI for § 221 purposes = $2,500
  $2,500 ÷ $30,000 = .08333 (8.333%) deduction remaining
  $2,500 maximum interest before phaseout x 8.3% = $208 deduction
QUALIFIED RESIDENCE INTEREST and POINTS

Interest paid on a loan secured by a mortgage on a personal residence is deductible only if it is qualified residence interest as defined in § 163(h)(3). Interest that does not meet these requirements is personal interest and not deductible.

Acquisition Debt § 163(h)(3)(B)

Acquisition debt is debt on a home incurred to acquire, construct, or substantially improve a qualified residence, secured by a mortgage on the home. Code § 163(h)(4) defines a qualified residence as the principal residence and one other residence of the taxpayer.

Example 1

Freed purchased a condo for $250,000, paying $50,000 down and borrowing $200,000 at 5¼% interest for 30 years from a bank. The loan qualifies as acquisition debt because the proceeds were used to acquire a residence, a mortgage on the home secures the loan, and the loan does not exceed $1 million. The interest on this loan is deductible. If Freed’s parents had lent her the $200,000 but did not record a mortgage to secure the debt, the interest would not be deductible.

Home Equity Debt §163(h)(3)(C)

Home equity debt is debt secured by a mortgage on a residence that was not used to acquire or improve the home. Interest on up to $100,000 of home equity debt is deductible.

Homeowners often obtain a “home equity” loan or line of credit, secured by a mortgage on the home, to pay for college expenses, cars, vacations, weddings, and other expenditures not connected with the home. Up to $100,000 of this debt is home equity debt and the interest on it is deductible. The total of all home equity debt cannot exceed $100,000.

Example 2

Seifert purchased a home in 2000 for $300,000, secured by a $250,000 mortgage. He bought a boat in 2006 for $30,000 but did not want to finance it with a consumer loan because interest on consumer debt is not deductible. He obtained a $30,000 home equity loan, secured by a mortgage on the home, and used the proceeds to buy the boat. The loan qualifies as home equity debt and the interest is deductible.

Refinancing Acquisition Debt

When a homeowner refines a loan, she obtains a new loan, usually at a lower interest rate than the original loan, and the proceeds are used to pay off the original loan. Debt incurred to refinance acquisition debt is considered acquisition debt to the extent of the balance of the original mortgage when it is refinanced.

Example 3

Joyce purchased a $350,000 home in 1996 with a 10% $300,000 mortgage loan. The balance of the loan was $280,000 in 2006 when she refinanced it with a $280,000 5% mortgage loan. The new loan is acquisition debt and the interest is deductible. If the new loan exceeds the balance of the original loan, the first $100,000 of excess debt is home equity debt and the balance is personal debt.
Example 4

Engert purchased a home fourteen years ago for $400,000 and it is now worth $1 million. She refinanced the $280,000 balance of the 9% first mortgage loan with a 5½% $800,000 loan and used the proceeds as follows:

- $280,000 to repay the first loan;
- $220,000 to remodel the kitchen and add a swimming pool;
- $150,000 for her daughter’s wedding;
- $100,000 for a three-month trip around the world;
- $50,000 for jewelry.

The $280,000 of the proceeds that repaid the first loan and the $220,000 used to improve the home is acquisition debt. $100,000 of the loan is home equity debt and the $200,000 remaining is personal debt. Interest on $600,000 of this loan is deductible and interest on $200,000 is nondeductible personal interest.

TAX TREATMENT OF POINTS PAID

Lenders offer a lower interest rate on the loan if the borrower pays points at the time the loan is closed. One point equals 1% of the loan. Points paid to a lender are considered prepaid interest. The Code does not permit taxpayers to deduct expenses paid in advance. However § 461(g)(2) provides an exception for “points paid in connection with the purchase or improvement of, and secured by, the principal residence.” Homeowners may deduct the points paid on a loan to acquire or improve a home in the year they pay the points. Points paid to refinance acquisition debt or for a home equity loan are deductible over the life of the loan.

Example 5

Taylor bought a home for $200,000 in 1995 and borrowed $170,000 at 12%; he paid two points to secure this “low” rate. He deducted the $3,400 of points ($170,000 x 2%) in 1995.

In 2003, he purchased a yacht financed with a 6% $80,000 10-year home equity loan and paid two points ($1,600). Interest on the $80,000 loan is deductible as home equity debt and he deducts $160 of the points each year for the 10-year life of the loan. The points are not deductible in full in 2003 because the loan proceeds were not used to acquire or improve the home.

By 2006, interest rates had declined and he refinanced both loans with a $400,000 4½% 15-year loan and paid two points ($8,000). He used $100,000 of the proceeds to improve his home. At the time he refinanced, the balance of the 1995 loan was $150,000 and the balance of the 2003 loan was $62,000. The points on this loan are treated as follows:

- $100,000 of the debt (25% of the loan total) is acquisition debt incurred to improve the home so $2,000 (25% of the points) is deductible in 2006. $150,000 of the debt (37½% of the loan total) is acquisition debt because it refinanced the old acquisition debt. Points paid to refinance acquisition debt are deductible over the life of the loan. $3,000 (37½% of the points) is deductible over the life of the loan. $200 is deductible in 2006 ($3,000 ÷ 15).
$100,000 of the new loan is home equity debt. $2,000 (25% of the points) is also deductible over the life of the loan. $133 is deductible in 2006 ($2,000 ÷ 15). The last $50,000 of the new loan is personal nondeductible debt so $1,000 (12½% of the points) is not deductible.

The points on the 2003 loan that the taxpayers have not deducted yet are deductible in full in 2006, the year they pay the balance of the loan. However, this is only permissible if the new loan is with a different lender. If the loan is refinanced with same mortgagee, they must deduct the points on the old loan over the term of new loan.

**Summary of Example 5**

<table>
<thead>
<tr>
<th>$400,000 Loan</th>
<th>$8,000 Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000 (25%) is acquisition debt to improve home</td>
<td>$2,000 (25%) deductible in 2006</td>
</tr>
<tr>
<td>$150,000 (37½%) is refinanced acquisition debt</td>
<td>$3,000 (37½%) deductible over 15-year life of loan ($3,000 ÷ 15 years = $200 deductible in 2006)</td>
</tr>
<tr>
<td>$100,000 (25%) is home equity debt</td>
<td>$2,000 (25%) deductible over 15-year life of loan ($2,000 ÷ 15 years = $133 deductible in 2006)</td>
</tr>
<tr>
<td>$50,000 (12½%) is personal debt</td>
<td>$1,000 (12½%) of points are not deductible</td>
</tr>
</tbody>
</table>
QUALIFIED RESIDENCE INTEREST PROBLEMS

How would you characterize the debt in each problem and how much of the interest is deductible?

Problem 1
(a) Rapoport bought a home on April 5, 2000 for $250,000 and obtained a $175,000 mortgage loan.

(b) On March 12, 2006, Rapport obtained a home equity loan for $150,000 and used the proceeds to purchase an airplane for personal purposes.

(c) Fong purchased a $1,500,000 home and financed it with a $1,200,000 mortgage loan.

Problem 2
(a) Hanson purchased a home on October 16, 2001 for $400,000 and financed it with a $300,000 mortgage loan at 9% interest.

(b) On February 12, 2006, when the principal balance of the loan was $240,000 and the value of the home was $500,000, he refinanced the loan with a $400,000 loan at 5½% interest. He used the $160,000 of extra funds for personal purposes.

(c) Same as (b) except he used $120,000 of the new loan to make improvements in the home.

(d) On June 1, 2006, Hanson took out a $70,000 home equity loan to pay for his daughter’s wedding. How should they characterize this debt?
SALES TAXES

The American Jobs Creation Act of 2004 changed the law for 2004 and 2005 with respect to the deductibility of sales taxes. State and local sales taxes had been nondeductible since 1986 (unless attributable to the taxpayer’s trade or business). However, under new § 164(b)(5), a taxpayer may elect to deduct state and local general sales taxes instead of state and local income taxes. The provision reflects the efforts of states that rely heavily on sales taxes to have these taxes treated under the Code the same as state and local income taxes. The provision expired at the end of 2005, but late in 2006, Congress extended the deduction for tax years 2006 and 2007.

A taxpayer making the election may deduct either sales taxes actually paid, or an amount determined under tables published by the Service. A taxpayer who uses the optional tables, that are based on the taxpayer’s state of residence, filing status, adjusted gross income, and number of exemptions, may also deduct sales taxes paid on homes, motor vehicles, boats and certain other items. To be deductible, a sales tax must be a general one, imposed at one rate with respect to a broad range of items, although an exception is made for special rates on food, clothing, medical supplies and motor vehicles. § 164(b)(5)(B), (C), (H).

Illinois Sales Tax Table

<table>
<thead>
<tr>
<th># of Exemptions</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
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<tbody>
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<td>Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>$0 $20,000</td>
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<td>233</td>
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<td>200,000 or more</td>
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<td>1805</td>
<td>1969</td>
<td>2096</td>
<td>2201</td>
<td>2347</td>
</tr>
</tbody>
</table>

The income is based on AGI. A couple using the optional sales tax table with AGI of $125,000 and two dependent children can deduct $1,261 for sales tax in addition to sales tax paid for a car and certain other major purchases.
PRORATION OF REAL PROPERTY TAXES

Homeowners pay real property taxes one year in arrears in Illinois. In October 2005, homeowners received their final 2004 property tax bill and paid the balance due. In February 2006, they paid the first installment of the 2005 property tax, which was 50% of the 2004 bill. Homeowners received their 2005 property tax bill in August 2006 and will pay the balance of the tax in September 2006. When property is sold, the parties must prorate the property tax according to the period of time each owned the home. The following example will illustrate how the parties prorate the taxes.

Allison owned a condominium in Elmhurst and on June 1, 2006 contracted to sell it to Matt; the closing was scheduled for June 30, 2006. The contract stated that the property tax will be prorated based on the most recent actual tax bill.

October 2005: Allison received the 2004 property tax bill of $3,780 and paid the second installment.

February 2006: She paid the $1,890 first installment of the 2005 tax bill (50% of $3,780).

June 30, 2006: The sale of the condo was closed and she gave Matt a credit of $3,780 for her share of the property tax, calculated as follows. The proration was based on the last actual tax bill, $3,780 for 2004. She lived in the condo for 18 months in 2005 and 2006; she is responsible for the entire 2005 property tax bill and one-half of the 2006 tax. She paid $1,890 for the first installment of the 2005 tax.

\[
\frac{3,780}{12 \text{ months}} = 315 \text{ per month} \\
315 \text{ per month} \times 18 \text{ months} = 5,670 \\
5,670 - 1,890 \text{ first installment paid} = 3,780
\]

August 2006: Matt received the final 2005 tax bill of $4,347 (a 15% increase) and he paid $2,457 ($4,347 tax - the $1,890 first installment paid by Allison).

February 2007: Matt paid the $2,174 first installment of the 2006 tax (50% of $4,347).

October 2007: Matt received the 2006 tax bill of $4,782 (a 10% increase) and he paid the $2,608 balance due ($4,782 tax - the $2,174 first installment he paid).

Summary

Allison’s “actual” share of the 18 months of property tax is $6,521 ($4,347 for 2005 and $2,174 for 2006, one-half of the $4,782 tax). However she paid only $5,670 ($1,890 first installment of the 2005 tax plus $3,780 to Matt at the closing). Matt had to pay the $851 extra tax.

Allison deducts $5,670 of property tax she paid in 2006 on her 2006 tax return ($1,890 first installment plus $3,780 paid to Matt at the closing). Matt cannot deduct any property tax on his 2006 return for the 2005 tax he paid in 2006. In 2007, he can deduct only $2,391 of the $4,782 he paid in 2007. That represents the tax for the six months he lived there in 2006. He cannot deduct the extra $851 of property tax he paid.

Moral of the Story

Matt should have negotiated a provision in the contract that required property taxes to be prorated based on 110% or another percentage of the last known tax bill. Matt had to pay the full increase in the property tax because he did not have this provision. This is especially important in a year property values are reassessed. The year following reassessment, the property tax can jump 50% or more, depending on the location of the property.
ISSUE
Whether the taxpayer’s costs for male-to-female gender reassignment surgery (and related medications, treatments, and transportation) paid during Year 6 may be deducted as medical expenses under I.R.C. § 213.

CONCLUSION
Without an unequivocal expression of Congressional intent that expenses of this type qualify under section 213, allowing the medical expense deduction is not justified in this case.

FACTS
The subject non-docketed case is currently under consideration by the Office of Appeals. On the taxpayer’s Year 6 return, the taxpayer reported medical and dental expenses for an amount exceeding $X. After applying the 7.5% limitation to adjusted gross income, the taxpayer claimed a deduction for medical and dental expenses in the amount of $Y. The expenses included payments for various doctors, prescriptions, health insurance, transportation and lodging in connection with the taxpayer’s gender reassignment surgery (GRS).

In a report dated July 2, Year 8, the Revenue Agent disallowed the expenses on the ground that they were for cosmetic surgery and nondeductible pursuant to I.R.C. section 213(d)(9). Based on documents provided by the taxpayer’s representative to the Appeals Officer, including letters prepared by medical professionals who treated the taxpayer, the following is a synopsis of the taxpayer’s medical condition and treatments:

1. The taxpayer grew up with a condition known as Gender Identity Disorder (GID).
2. It is not clear from the records when the taxpayer first realized that he had some type of disorder, but it was suggested that the taxpayer had gender issues dating back to childhood.
3. Beginning in Year 1, the taxpayer sought psychotherapy from licensed social worker A.
4. During the course of treatment, Social Worker A formally diagnosed the taxpayer as meeting the criteria for Gender Identity Disorder.
5. In September, Year 2, subsequent to the diagnosis, the taxpayer began hormone treatment under the care of an endocrinologist.
6. In March, Year 5, the taxpayer began living as a full-time female.
7. In March, Year 5, the taxpayer legally changed his name from Taxpayer 2 to Taxpayer Name 1.
8. In July, Year 6, Social Worker A, in accordance with medical standards that were followed for treatment of Gender Identity Disorder, recommended the taxpayer for Gender Reassignment Surgery (GRS).
9. In July, Year 6, the taxpayer met with Doctor B to be evaluated as to whether GRS was an appropriate treatment for his diagnosed GID.
10. Doctor B considered the taxpayer’s GID to be profound. Several alternative treatments were considered and dismissed. Doctor B ultimately opined that the taxpayer was in need of GRS.
11. Prior to surgery, the taxpayer complied with the preparatory requirements for sex reassignment surgery. These standards are known as the Harry Benjamin Standards. See Harry Benjamin International Gender Dysphoria Association’s Standards of Care for Gender Identity Disorders.
12. In October Year 6, the taxpayer underwent GRS.

**LAW AND ANALYSIS**

I.R.C. § 213(d)(1)(A) defines the term “medical care” as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. See also Treas. Reg. § 1.213-1(e)(1)(i).

I.R.C. § 213(d)(9)(A) provides that the term “medical care” does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease. I.R.C. § 213(d)(9)(B) defines “cosmetic surgery” as any procedure that is directed at improving the patient’s appearance and does not meaningfully promote the proper function of the body or treat illness or disease.

* * * Congress enacted I.R.C. § 213(d)(9), with the Omnibus Budget Reconciliation Act of 1990, which specifically defined cosmetic surgery as “any procedure which is directed at improving the patient’s appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.” Because this exact language was ultimately enacted as I.R.C. § 213(d)(9)(B), it is important to analyze the Senate Report regarding this provision.

* * * The Senate Report states that expenses for purely cosmetic procedures that are not medically necessary are, in essence, voluntary personal expenditures, which like other personal expenditures (e.g., food and clothing) generally should not be deductible in computing taxable income. In discussing the types of surgery which are deemed to be medically necessary, the Senate Report lists only: (1) procedures that are medically necessary to promote the proper function of the body and which only incidentally affect the patient’s appearance; and (2) procedures for treatment of a disfiguring condition arising from a congenital abnormality, personal injury, trauma, or disease (such as reconstructive surgery following the removal of a malignancy).

From the material submitted the taxpayer has not satisfactorily demonstrated that the expenses incurred for the taxpayer’s GRS fit within the strict boundaries discussed above. There is nothing to substantiate that these expenses were incurred to promote the proper function of the taxpayer’s body and only incidentally affect the taxpayer's appearance. The expenses also were not incurred for treatment of a disfiguring condition arising from a congenital abnormality, personal injury, trauma, or disease (such as reconstructive surgery following the removal of a malignancy).

Whether gender reassignment surgery is a treatment for an illness or disease is controversial. For instance, Johns Hopkins Hospital has closed its gender reassignment clinic and ceased performing these operations. See, Surgical Sex, Dr. Paul McHugh, 2004 First Things 147 (November 2004) 34-38. To our knowledge, there is no case law, regulation, or revenue ruling that specifically addresses medical expense deductions for GRS or similar procedures. In light of the Congressional emphasis on denying a deduction for procedures relating to appearance in all but a few circumstances and the controversy surrounding whether GRS is a treatment for an illness or disease, the materials submitted do not support a deduction. Only an unequivocal expression of Congressional intent that expenses of this type qualify under section 213 would justify the allowance of the deduction in this case. Otherwise, it would seem we would be moving beyond the generally accepted boundaries that define this type of deduction. This advice may not be used or cited as precedent.
MEDICAL EXPENSE PROBLEMS

Which of the following expenses are deductible?

1. $80 per day cost of a hotel room one block from Mayo clinic for a Chicago resident while undergoing outpatient treatment, § 213(d)(2)

2. cab to doctor’s office for routine physical, § 213(d)(1)(B)

3. payments to a faith healer to cure arthritis, § 213(d)(1)(A)

4. a calcium supplement to help combat osteoporosis, § 213(b)

5. $30,000 to install an elevator in the home for medical reasons, which increases the value of the home by $25,000. reg. § 1.213-1(e)(iii)

6. acupuncture treatments, § 213(d)(1)(A)

7. breast augmentation, § 213(d)(9)

8. medical insurance premiums, § 213(d)(1)(D)

9. a marriage counselor, § 213(d)(1)(A)

10. marijuana to reduce nausea from chemotherapy, reg. § 1.213-1(e)(ii)
CHARITABLE CONTRIBUTIONS LECTURE

1. **What is Deductible?** The FMV of cash and property; not services.

2. **Qualified Recipients**: religious, charitable, scientific, literary, educational organizations and some others (§ 501(c)(3)); never a private individual

3. **Indirect Subsidy** from the government

4. **Donative Intent**
   can only deduct the excess of the FMV over the value of what is received from the charity

5. **When Deductible**

6. **Amount and Character of Deduction** (itemized deduction)
   ordinary income property: deduct lower of FMV or basis
   long-term capital gain property:
   if FMV exceeds basis, deduct FMV; no tax is paid on the appreciation
   used clothing, appliances, and President Clinton’s underwear

7. **Deduction Limits**
   50% of contribution base (AGI) for cash and ordinary income property
   30% of contribution base for LTCG property
   deductions in excess of maximum may be carried over for 5-years

8. **Substantiation**
   receipt required if more than $75 for “quid pro quo” donations or more than $250 for other donations;
   appraisal required if property exceeds $5,000
   donee must report sale price to IRS if sold within two years

9. **Donating Cars to Charities**
   A taxpayer may not deduct the contribution of a used car, boat or airplane until she receives an acknowledgment from the charity that the property has been sold. The deduction is limited to the sale proceeds. Code § 170(f)(12)(A).
EFFECTIVE TAX SAVINGS

For taxpayers who itemize their deductions, the effective reduction in taxable income is the amount by which their itemized deductions exceed the standard deduction. For example, a married couple with $14,000 of itemized deductions will itemized their deductions because they exceed the $10,300 standard deduction. However, if they did not have enough deductions to itemize, they would have deducted the $10,300 standard deduction.

Their $14,000 of itemized deductions reduce their taxable income by only $3,700 more than the standard deduction. If they are in the 25% bracket, their itemized deductions save them $925 of tax ($3,700 x 25%).

Problem 1
A married couple has $15,000 of mortgage interest and real estate taxes, $1,200 of charitable contributions, and $2,000 of state income tax. How much tax will the mortgage interest and real estate taxes save them if they are in the 25% bracket?

Problem 2
A single taxpayer has $1,000 of charitable donations, $1,200 of and state income tax, and $9,000 of unreimbursed medical expenses, primarily for his psychologist. His AGI is $80,000. How much tax will the itemized deductions save him if he is in the 25% bracket?

Solutions

Problem 1: $1,975
$18,200 itemized deductions - $10,300 standard deduction = $7,900 reduction of taxable income
$7,900 x 25% bracket = $1,975 tax savings

Problem 2: $12.50
medical expenses:

$80,000 AGI x 7.5% = $6,000
$9,000 medical expenses - $6,000 floor = $3,000 deductible medical expenses

$3,000 medical expenses + $2,200 of other itemized deductions = $5,200 total itemized deductions
$5,200 itemized - $5,150 standard deduction = $50 reduction of taxable income
$50 x 25% = $12.50 tax savings
CAPITAL TRANSACTIONS

Definitions: The sale or exchange of capital assets held one year or less result in short-term capital gains or losses (STCG or STCL). The sale or exchange of capital assets held more than one year result in long-term capital gains or losses (LTCG or LTCL). Dividends are taxed at the same rate as long-term capital gains.

Tax Rates for Long-term Capital Gains and Dividends

<table>
<thead>
<tr>
<th>Rate</th>
<th>Applies to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>LTCG and dividends that fall in the 10 or 15% tax brackets (reduced to zero for 2008-2010).*</td>
</tr>
<tr>
<td>15%</td>
<td>LTCG and dividends that fall in a bracket higher than 15%.</td>
</tr>
<tr>
<td>25%</td>
<td>Recaptured gain from the sale of real property (RE LTCG) that falls in a bracket higher than 25%.</td>
</tr>
<tr>
<td>28%</td>
<td>LTCG from the disposition of collectibles (art, antiques, stamps, coins, etc.) and gains from the sale of qualified small business company stock eligible for the 50% exclusion. We will not study this category; you will not be responsible for these gains.</td>
</tr>
</tbody>
</table>

* Beginning in 2008, full-time students up to age 24 may not use the 5% or zero percent rate. This will be discussed in more detail when we study the “kiddie tax.”

Computing the Tax on LTCG and Deducting Capital Losses

Step 1. Classify Capital Gains and Losses

Make a 3-column worksheet and label the columns STCG(L), RE LTCG, and LTCG(L), similar to the columns on the tax computation worksheet. Enter the gain or loss from the sale of each capital asset in the appropriate column. Make sure to put parentheses around losses you enter in the worksheet. When real property is sold, enter the gain attributable to depreciation in the RE LTCG column and enter the balance of the gain, if any, in the LTCG(L) column. (Review the character of gain or loss of real property in the depreciation handout.) After you enter each transaction in the appropriate column, total the columns.

Example 1

Ahmed, a single taxpayer, earned $60,000 of salary and had the following gains and losses: (A) $8,000 STCG; (B) $7,000 STCG; (C) $4,000 STCL; (D) $2,000 LTCG; (E) sold RE for a $20,000 gain; $9,000 is RE LTCG and $11,000 is LTCG. After entering each transaction in the appropriate column and totaling the columns, the worksheet looks like this:

<table>
<thead>
<tr>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) 8,000</td>
<td>(E) 9,000</td>
<td>(D) 2,000</td>
</tr>
<tr>
<td>(B) 7,000</td>
<td></td>
<td>(E) 11,000</td>
</tr>
<tr>
<td>(C) (4,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>totals 11,000</td>
<td>9,000</td>
<td>13,000</td>
</tr>
</tbody>
</table>

If the total of all columns are gains, the total gain is capital gain net income (CGNI) and is added to gross income. Ahmed has $93,000 of gross income ($33,000 CGNI plus $60,000 of salary). When the columns are totaled, capital losses are being subtracted from capital gains, as in the STCG(L) column above.
Step 2. **Net (Combine) Capital Gains and Losses**

A. **Net Long-term Gains and Losses**

In all of the following examples, the column totals before netting gains and losses are in bold type. If some column totals are gains and others are losses, the gains and losses have to be offset against each other. Begin with LTCL and RE LTCG (they are both long-term gains). The RE LTCG column total can only be a gain or zero. If there is RE LTCG and LTCL, net the gain and loss by subtracting the smaller amount from the larger amount. If the LTCL loss exceeds the RE LTCG, subtract the RE LTCG from the LTCL, as in the following example. The result is a net long-term capital loss.

**Example 2**

<table>
<thead>
<tr>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4,000</td>
<td>(11,000)</td>
</tr>
<tr>
<td></td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td><strong>totals</strong></td>
<td><strong>7,000</strong></td>
<td><strong>(11,000)</strong></td>
</tr>
<tr>
<td></td>
<td>-7,000</td>
<td>+7,000</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>(4,000)</td>
</tr>
</tbody>
</table>

If the RE LTCG exceeds the LTCL, subtract the LTCL from the RE gain, as shown below.

**Example 3**

<table>
<thead>
<tr>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>14,000</td>
<td>(11,000)</td>
</tr>
<tr>
<td></td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td><strong>totals</strong></td>
<td><strong>19,000</strong></td>
<td><strong>(11,000)</strong></td>
</tr>
<tr>
<td></td>
<td>-11,000</td>
<td>+11,000</td>
</tr>
<tr>
<td></td>
<td>8,000</td>
<td>0</td>
</tr>
</tbody>
</table>

B. **Net Short-term and Long-term Gains and Losses**

After netting the LTCL and RE LTCG, if there is long-term gain (either LTCG or RE LTCG) and STCL, or vice versa, subtract the smaller amount from the larger amount. In the following example, the RE LTCG was less than the LTCL so it was subtracted from the LTCL, resulting in a $4,000 long-term loss. This loss was smaller than the $5,000 STCG so it was subtracted from the STCG, resulting in a net STCG of $1,000.

**Example 4**

<table>
<thead>
<tr>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5,000</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>3,000</td>
<td>(11,000)</td>
</tr>
<tr>
<td><strong>totals</strong></td>
<td><strong>5,000</strong></td>
<td><strong>7,000</strong></td>
</tr>
<tr>
<td></td>
<td>-7,000</td>
<td>+7,000</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>(4,000)</td>
</tr>
<tr>
<td></td>
<td>-4,000</td>
<td>+4,000</td>
</tr>
<tr>
<td></td>
<td>1,000</td>
<td></td>
</tr>
</tbody>
</table>
Example 5

<table>
<thead>
<tr>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(15,000)</td>
<td>7,000</td>
<td>7,000</td>
</tr>
<tr>
<td></td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>totals</td>
<td>(15,000)</td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>7,000</td>
</tr>
<tr>
<td>+ 12,000</td>
<td>- 12,000</td>
<td></td>
</tr>
<tr>
<td>(3,000)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>+ 3,000</td>
<td>- 3,000</td>
<td></td>
</tr>
<tr>
<td>0</td>
<td></td>
<td>4,000</td>
</tr>
</tbody>
</table>

In this example, the taxpayer had gains in both long-term columns and a loss in the short-term column. The gains exceeded the loss so the loss is subtracted from the gains. STCL is subtracted from RE LTCG first and the remainder, if any, is subtracted from LTCG. $12,000 of STCL was subtracted from RE LTCG, reducing it to zero; the $3,000 balance was subtracted from the $7,000 LTCG, reducing it to $4,000.

This method of netting gains and losses is favorable to the taxpayer because the STCL loss is subtracted from the higher-taxed RE LTCG first and then from the lower-taxed LTCG. In other words, the STCL first reduced the gain with a maximum tax rate of 25% and then reduced the gain with a maximum tax rate of 15%.

Step 3. Deduct Net Capital Loss

If capital losses exceed all capital gains, the losses are deductible under § 165(c)(2) as losses from transactions entered into for profit. Code § 62(3) classifies the capital loss deduction as an adjustment. Code § 1211(b) limits the deductible loss to the lesser of the loss or $3,000. In other words, the lesser of the capital loss or $3,000 is deductible as an adjustment.

When capital losses exceed $3,000 in a year, the excess is carried over to the next year and retains its character as long-term or short-term. If the taxpayer has both ST and LT losses, she deducts short-term losses before long-term losses to determine which losses are carried over to the next year. In the following example, $3,000 of STCL is deducted as an adjustment; $12,000 of STCL and $10,000 of LTCL is carried over to next year. The amounts carried over are entered in next year’s ST and LT capital columns as losses and are part of the next year’s netting process.

Example 6

<table>
<thead>
<tr>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>7,000</td>
<td>(17,000)</td>
</tr>
<tr>
<td>totals</td>
<td></td>
<td>(7,000)</td>
</tr>
<tr>
<td></td>
<td>- 7,000</td>
<td>+ 7,000</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>(10,000)</td>
</tr>
</tbody>
</table>

If this taxpayer’s gross income was $78,000, her MAGI for purposes of the passive loss would be $75,000, after subtracting the $3,000 capital loss adjustment. $12,000 of STCL and $10,000 of LTCL would be carried over to the following year. Capital losses are carried forward indefinitely until the taxpayer dies. In other words, if a taxpayer had a $48,000 capital loss in 2001 and never had any future gains, she can deduct $3,000 per year for the next sixteen years. When she dies, the remaining capital loss disappears.
Step 4. Determine Capital Gain Net Income and Net Capital Gain

Capital Gain Net Income (CGNI)

If capital gains exceed capital losses, the gain is capital gain net income (CGNI) and is added to gross income. CGNI consists of STCG, LTCG and RE LTCG (but not dividends). The total of the dividend column is added to gross income separately.

Net Capital Gain (NCG)

Net capital gain (NCG) is the income entitled to the maximum 5% or 15% tax rates. Dividends are taxed at the same rates as LTCG, so NCG is the total of LTCG and dividends. Note: LTCG and dividends are already included in gross income. The NCG amount is used in the tax computation as will be explained below. STCG is taxed with other ordinary income.

To summarize: CGNI is included in gross income and includes LTCG, STCG and RE LTCG. NCG is used in the tax computation and includes LTCG and dividends.

Example 7

Atkin has $7,000 of dividends, $10,000 LTCG, $4,000 STCG and $7,000 RE LTCG. Her **CGNI is $21,000** ($10,000 LTCG, $4,000 STCG and $7,000 RE LTCG) and is added to gross income. Dividends are entered in the dividend column of the worksheet and are included in gross income. Her **NCG is $17,000** ($10,000 LTCG plus $7,000 of dividends).

Example 8

Kelly has $5,000 of LTCL and $4,000 of dividends. She has no CGNI, but the dividends are NCG. Kelly deducts $3,000 of capital loss and carries $2,000 long-term loss to next year. The dividends are NCG and are taxed at the 5% or 15% maximum rates, as illustrated next.

Example 9

Oskin has $12,000 STCG and $4,000 LTCL; his CGNI is $8,000. He has no NCG, so the CGNI is taxed at regular rates.
Step 5: Calculate the Tax

Step 1. Calculate taxable income by adding gross income (including CGNI and dividends), subtracting adjustments, itemized deductions or the standard deduction and exemptions.

Step 2. Subtract NCG (LTCG and dividends) and RE LTCG from taxable income to arrive at regular taxable income (RTI), which is taxed at the regular rates.

Step 3. Calculate the tax on RTI using the tax calculator or h/o 1.

Step 4. Calculate the tax on NCG and RE LTCG as follows:

(a) The 15% bracket ends at $30,650 on a single return and at $61,300 on a joint return. If RTI exceeds those amounts, RE LTCG is taxed at 25% and NCG is taxed at 15%.

(b) If RTI is less than $30,650 or $61,300 on a joint return, compute the tax on RE LTCG next. RE LTCG that falls in the 10% or 15% brackets is taxed at those rates. RE LTCG that falls above the 15% bracket is taxed at 25%.

(c) NCG is taxed last. NCG that falls in the 10% or 15% bracket is taxed at 5%; NCG that falls in a bracket higher than 15% is taxed at 15%.

Step 5. Add the tax on RTI, RE LTCG, and NCG to arrive at the total tax.

The 2006 tax brackets end at the following amounts of taxable income:

<table>
<thead>
<tr>
<th></th>
<th>single return</th>
<th>joint return</th>
</tr>
</thead>
<tbody>
<tr>
<td>end of 10% bracket</td>
<td>$7,550</td>
<td>$15,100</td>
</tr>
<tr>
<td>end of 15% bracket</td>
<td>$30,650</td>
<td>$61,300</td>
</tr>
</tbody>
</table>

The following examples illustrate the computation.

Example 10

The Kims have $150,000 of taxable income, which includes:

$12,000 LTCG
$5,000 RE LTCG
$4,000 of dividends

They calculate their tax as follows:

taxable income       $150,000
- NCG                - 16,000 (LTCG and dividends)
- RE LTCG            - 5,000
RTI                   $129,000

RTI exceeds $61,300; RE LTCG is taxed at 25% and NCG is taxed at 15%.

tax on 129,000 RTI at regular rates     $25,524
tax on 5,000 RE LTCG @ 25%             1,250
tax on 16,000 NCG @ 15%                2,400
total tax                           $29,174
Example 11
Nussbaum, a single taxpayer, has $32,000 of taxable income, including $17,000 of LTCG. RTI is $15,000 RTI, which does not exceed $30,650, so NCG that falls in the 10% and 15% bracket is taxed at 5%; NCG that falls above the 15% bracket is taxed at 15%. (See step 4(c) above.)

The 15% bracket ends at $30,650. $15,650 of NCG ($30,650 top of bracket - $15,000 RTI) falls in the 10 or 15% bracket and is taxed at 5%. The $1,350 balance of NCG falls in a bracket higher than 15% and is taxed at 15%. His tax is computed as follows:

- tax on $15,000 RTI at regular rates $1,873
- tax on $15,650 NCG in the 15% bracket @ 5% 783
- tax on $1,350 NCG in the 25% bracket @ 15% 203
- total tax $2,859

Example 12
The Schmidts have $200,000 of taxable income, including $180,000 of RE LTCG. Their RTI is $20,000 ($200,000 taxable income - $180,000 RE LTCG), which does not exceed $61,300. RE LTCG that falls in the 10% or 15% brackets is taxed at those rates; RE LTCG that falls in a bracket above the 15% is taxed at 25%.

The 10% bracket ends at $15,100 on a joint return; RTI exceeds that amount so none of the RE LTCG falls in the 10% bracket. The 15% bracket ends at $61,300. $41,300 of RE LTCG ($61,300 end of bracket - $20,000 RTI) falls in the 15% bracket and is taxed at 15%. The $138,700 balance of RE LTCG falls in a bracket higher than 15% and is taxed at 25%. They compute their tax as follows:

- tax on 20,000 RTI at regular rates $2,245
- tax on 41,300 RE LTCG @ 15% 6,195
- tax on 138,700 RE LTCG @ 25% 34,675
- total tax $43,115
Example 13

The previous examples started with taxable income from which NCG and RE LTCG were subtracted to arrive at RTI. This example gives the taxpayer’s transactions and will illustrate the tax computation from the beginning. This is the way you will compute the tax on the final exam.

Tuttle, a single taxpayer, has the following amounts on his 2006 worksheet: $13,450 salary in the ordinary income column; $5,000 in the dividends column; $3,000 in the RE LTCG column and $18,000 gain in the LTCG(L) column. The standard deduction exceeds her itemized deductions.

CGNI is $21,000 ($3,000 RE LTCG plus $18,000 LTCG)
NCG is $23,000 ($5,000 dividends plus $18,000 LTCG)

She calculates her taxable income as follows:

<table>
<thead>
<tr>
<th>gross income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>salary</td>
<td>$13,450</td>
</tr>
<tr>
<td>dividends</td>
<td>5,000</td>
</tr>
<tr>
<td>CGNI</td>
<td>21,000</td>
</tr>
</tbody>
</table>

MAGI for passive loss purposes and AGI 39,450
minus standard deduction - 5,150
minus exemption - 3,300
equals taxable income 31,000

taxable income: 31,000
minus RE LTCG - 3,000
minus NCG - 23,000
equals RTI 5,000

Tuttle’s tax is calculated as follows:

tax on 5,000 of RTI $500
tax on 2,550 of RE LTCG @ 10% 255
tax on the 450 balance of RE LTCG @ 15% 68
tax on 22,650 of NCG @ 5% 1,133
tax on 350 balance of NCG @ 15% 53
total tax 2,009

RTI did not exceed $7,550, the end of the 10% bracket for single taxpayers, so $2,550 of RE LTCG ($7,550 end of 10% bracket - $5,000 RTI) is taxed at 10%. The $450 balance of RE LTCG falls in the 15% bracket and is taxed at 15%. $8,000 of taxable income has been taxed thus far ($5,000 of RTI plus $3,000 of RE LTCG).

The 15% bracket ends at $30,650 for single taxpayers. $22,650 of NCG falls in the 15% bracket ($30,650 end of bracket - $8,000 already taxed) and is taxed at 5%. The $350 balance of the NCG falls in a bracket above 15% and is taxed at 15%.

This computation is shown on the next page in tabular form that may help you visualize the way various amounts of income are taxed.
Example 13 Tax Computation

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax</th>
<th>Brackets for Single Taxpayers</th>
</tr>
</thead>
<tbody>
<tr>
<td>350 NCG taxed at 15%</td>
<td>53</td>
<td>bracket above 15%</td>
</tr>
<tr>
<td>22,650 NCG taxed at 5%</td>
<td>1,133</td>
<td>15% bracket ends at $30,650</td>
</tr>
<tr>
<td>+ 450 RE LTCG taxed at 15%</td>
<td>68</td>
<td>($30,650 - $7,550 in 10% bracket = $23,100 in 15% bracket)</td>
</tr>
<tr>
<td>23,100 total in 15% bracket</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2,550 RE LTCG taxed at 10%</td>
<td>255</td>
<td>10% bracket ends at $7,550</td>
</tr>
<tr>
<td>+ 5,000 RTI taxed at 10%</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>7,550 total in 10% bracket</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>total tax</strong></td>
<td><strong>2,009</strong></td>
<td></td>
</tr>
</tbody>
</table>

Effective Rate of Net Capital Gain

NCG is taxed at favorable rates, but because it is included in gross income, it increases AGI and reduces the exclusions, deductions and credits listed below. By reducing or eliminating some of these benefits, the effective rate of tax for NCG is higher than 5% or 15%, as shown in the example on the next page.

- adoption credit and exclusion
- Social Security benefits exclusion
- interest exclusion on educational savings bonds
- child tax credit
- dependent care credit
- earned income tax credit
- Hope and Lifetime Learning credits
- personal exemptions
- IRA eligibility
- casualty loss deduction
- 2% MIDs
- itemized deductions
- medical deduction
- tuition deduction
- real estate passive loss deduction
- student loan interest deduction
Example of Effective Tax Rate of NCG

Example 14
The Kellys, a married couple, had $116,000 of salaries and a $20,000 LTCG. They paid $15,000 of tuition for graduate school and $3,000 of student loan interest. Their MAGI for purposes of the § 221 student loan interest deduction is $136,000, so it is completed phased out. Their MAGI for purposes of the § 222 deduction is $136,000, so their deduction is $2,000, not $4,000. They calculate their tax as follows:

Tax Computation with the $20,000 LTCG

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>gross income</td>
<td>$136,000</td>
</tr>
<tr>
<td>minus adjustments</td>
<td>0</td>
</tr>
<tr>
<td>MAGI for passive losses</td>
<td>136,000</td>
</tr>
<tr>
<td>minus passive losses</td>
<td>0</td>
</tr>
<tr>
<td>§ 221 MAGI</td>
<td>136,000</td>
</tr>
<tr>
<td>minus student loan interest</td>
<td>0</td>
</tr>
<tr>
<td>§ 222 MAGI</td>
<td>136,000</td>
</tr>
<tr>
<td>minus § 222 tuition deduction</td>
<td>-2,000</td>
</tr>
<tr>
<td>AGI</td>
<td>134,000</td>
</tr>
<tr>
<td>minus standard deduction</td>
<td>-10,300</td>
</tr>
<tr>
<td>minus exemptions</td>
<td>-6,600</td>
</tr>
<tr>
<td>taxable income</td>
<td>$117,100</td>
</tr>
<tr>
<td>taxable income minus NCG</td>
<td>-20,000</td>
</tr>
<tr>
<td>RTI</td>
<td>$97,100</td>
</tr>
<tr>
<td>tax on $97,100 RTI</td>
<td>$17,390</td>
</tr>
<tr>
<td>tax on $20,000 NCG @ 15%</td>
<td>3,000</td>
</tr>
<tr>
<td>total tax</td>
<td>$20,390</td>
</tr>
</tbody>
</table>

Tax Computation without the $20,000 LTCG

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>gross income</td>
<td>$116,000</td>
</tr>
<tr>
<td>minus adjustments</td>
<td>0</td>
</tr>
<tr>
<td>MAGI for passive losses</td>
<td>136,000</td>
</tr>
<tr>
<td>minus passive losses</td>
<td>0</td>
</tr>
<tr>
<td>§ 221 MAGI</td>
<td>116,000</td>
</tr>
<tr>
<td>minus § 221 interest*</td>
<td>-1,583</td>
</tr>
<tr>
<td>§ 222 MAGI</td>
<td>114,417</td>
</tr>
<tr>
<td>minus § 222 tuition deduction</td>
<td>-4,000</td>
</tr>
<tr>
<td>AGI</td>
<td>110,417</td>
</tr>
<tr>
<td>minus standard deduction</td>
<td>-10,300</td>
</tr>
<tr>
<td>minus exemptions</td>
<td>-6,600</td>
</tr>
<tr>
<td>taxable income</td>
<td>$93,517</td>
</tr>
<tr>
<td>tax:</td>
<td>$16,494</td>
</tr>
</tbody>
</table>

*$135,000 phaseout ceiling - $116,000 MAGI = $19,000 ÷ $30,000 = .633 x $2,500 = $1,583

tax with $20,000 LTCG            $20,390
tax without capital gain         -16,494
tax cost of $20,000 LTCG           $3,896

Effective tax rate of capital gain: $3,896 extra tax ÷ $20,000 capital gain = 19.5%
CAPITAL TRANSACTIONS PROBLEMS

Problem 1
Motto, a single taxpayer, had the following gains for all parts of problem 1 and the RTI specified in each subpart. Determine his tax using the RTI stated in each subpart.

$10,000 LTCG
$5,000 dividends
$3,000 RE LTCG

For example, if the RTI was $100,000, the tax would be $25,627, computed as follows:

\[
\begin{align*}
\text{tax on } 100,000 \text{ RTI} & \text{ (using h/o 1 or the tax calculator)} \quad 22,332 \\
\text{tax on } 3,000 \text{ RE LTCG @ 25%} & \quad 750 \\
\text{tax on } 15,000 \text{ NCG @ 15%} & \quad 2,250 \\
\text{total tax} & \quad 25,332
\end{align*}
\]

RTI
(a) $72,000
(b) $28,300
(c) $25,700

Instructions for Problems 2-4
The RTI stated in problems 2-4 is before taking account of the capital transactions stated in the problem. Determine the taxpayer’s NCG, if any, and RTI and after giving effect to the capital transactions. In addition, determine the amount and character of the capital loss carryover, if any. For example, if the capital transactions result in a net loss, RTI will be reduced by the amount of the deductible loss. Do not compute the tax. (I suggest that you enter the transactions for each problem in worksheet-type capital columns, then net the gains and losses.)

Problem 2
Griffin, a single taxpayer, had $12,000 STCG, $4,000 LTCG, $7,000 LTCL, and RTI of $17,000.

Problem 3
Rice, a single taxpayer, had $5,000 STCL, $4,000 LTCL and RTI of $17,000.

Problem 4
Conlon, a married taxpayer, had $2,000 STCL, $5,000 RE LTCG, $7,500 LTCL, $4,000 of dividends and RTI of $52,000.

Instruction for problems 5 and 6: Compute the 2006 tax in the following problems. Refer to Example 14 for the tax computation and h/o 1 for the exemption and standard deduction amounts.

Problem 5
Powers, a single taxpayer, had $6,000 STCG, $10,000 LTCL, $4,000 dividends and salary of $39,250.

Problem 6
The Fridmans, a married couple with no children, had the following income and deductions:
(a) $40,500 salary; (b) alimony paid: $10,000; (c) $5,000 tuition (they elect the § 222 deduction); (d) $7,000 RE LTCG; (e) $41,000 LTCG.
SOLUTIONS TO CAPITAL TRANSACTIONS PROBLEMS

Problem 1
Motto, a single taxpayer, had the following gains for all parts of problem 1 and the RTI specified in each subpart. Determine his tax using the RTI stated in each subpart.

$10,000 LTCG
$5,000 dividends
$3,000 RE LTCG

The 2006 tax brackets end at the following amounts of taxable income:

<table>
<thead>
<tr>
<th></th>
<th>single return</th>
<th>joint return</th>
</tr>
</thead>
<tbody>
<tr>
<td>end of 10% bracket</td>
<td>$7,550</td>
<td>$15,100</td>
</tr>
<tr>
<td>end of 15% bracket</td>
<td>$30,650</td>
<td>$61,300</td>
</tr>
</tbody>
</table>

(a) RTI $72,000

<table>
<thead>
<tr>
<th>Tax</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>tax on 72,000 RTI</td>
<td>$14,558</td>
</tr>
<tr>
<td>tax on 3,000 RE LTCG @ 25%</td>
<td>750</td>
</tr>
<tr>
<td>tax on 15,000 NCG @ 15%</td>
<td>2,250</td>
</tr>
<tr>
<td>Total tax</td>
<td>$17,558</td>
</tr>
</tbody>
</table>

(b) RTI $28,300

<table>
<thead>
<tr>
<th>Tax</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>tax on 28,300 RTI</td>
<td>3,868</td>
</tr>
<tr>
<td>tax on 2,350 RE LTCG @ 15%</td>
<td>353</td>
</tr>
<tr>
<td>tax on 650 balance of RE LTCG @ 25%</td>
<td>163</td>
</tr>
<tr>
<td>tax on 15,000 NCG @ 15%</td>
<td>2,250</td>
</tr>
<tr>
<td>Total tax</td>
<td>$6,634</td>
</tr>
</tbody>
</table>

(c) RTI $25,700

<table>
<thead>
<tr>
<th>Tax</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>tax on 25,700 RTI</td>
<td>3,478</td>
</tr>
<tr>
<td>tax on 3,000 RE LTCG @ 15%</td>
<td>450</td>
</tr>
<tr>
<td>tax on 1,950 NCG @ 5%</td>
<td>98</td>
</tr>
<tr>
<td>tax on 13,050 balance of NCG @ 15%</td>
<td>1,958</td>
</tr>
<tr>
<td>Total tax</td>
<td>$5,984</td>
</tr>
</tbody>
</table>

Problem 2
Griffin, a single taxpayer, had $12,000 STCG, $4,000 LTCG, $7,000 LTCL, and RTI of $17,000.

<table>
<thead>
<tr>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12,000</td>
<td>4,000</td>
<td>(7,000)</td>
</tr>
<tr>
<td>12,000</td>
<td></td>
<td>(3,000)</td>
</tr>
<tr>
<td>- 3,000</td>
<td>+ 3,000</td>
<td>0</td>
</tr>
<tr>
<td>9,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

No NCG; RTI is $26,000 ($17,000 + $9,000 STCG )
**Problem 3** Rice, a single taxpayer, had $5,000 STCL, $4,000 LTCL and RTI of $17,000.

RTI is $14,000 ($17,000 RTI - $3,000 capital loss deduction)  
STC is deducted before LTCL.  
$3,000 of STCL was deducted; 2,000 STCL and $4,000 LTCL are carried over to the next year.

**Problem 4** Conlon, a married taxpayer, had $2,000 STCL, $5,000 RE LTCG, $7,500 LTCL, $4,000 of dividends and RTI of $52,000.

\[
\begin{array}{|c|c|c|}
\hline
\text{STCG(L)} & \text{RE LTCG} & \text{LTCG(L)} \\
\hline
(2,000) & 5,000 & (7,500) \\
\hline
-5,000 & & +5,000 \\
\hline
0 & & (2,500) \\
\hline
\end{array}
\]

$5,000 RE LTCG is subtracted from LTCL, leaving $2,500 of LTCL.  
RTI is $49,000 ($52,000 - $3,000 capital loss deduction)  
NCG is $4,000 (dividends)  
STCL is deducted before LTCL, so all of the STCL and $1,000 of the LTCL is deducted.  
$1,500 of LTCL is carried over to the next year.

**Problem 5** Powers, a single taxpayer, had $6,000 STCG, $10,000 LTCL, $4,000 of dividends and salary of $39,250.

\[
\begin{array}{|c|c|c|}
\hline
\text{STCG(L)} & \text{RE LTCG} & \text{LTCG(L)} \\
\hline
6,000 & & (10,000) \\
\hline
-6,000 & & -6,000 \\
\hline
0 & & - (4,000) \\
\hline
\end{array}
\]

gross income  
 salary $39,250  
 dividends $4,000  
 total gross income $43,250  
 minus adjustments:  
 capital loss deduction $-3,000  
 AGI $40,250  
 minus standard deduction $-5,150  
 minus exemption $-3,300  
 equals taxable income $31,800  
 minus NCG (dividends) $-4,000  
 equals RTI $27,800

**Tax Computation**

tax on 27,800 RTI $3,793  
tax on 2,850 NCG @ 5% 143  
tax on 1,150 NCG @ 15% 173  
 total tax $4,109

$1,000 LTCL is carried over to next year.
### Problem 6

The Fridmans, a married couple with no children, had the following income and deductions.

- **(a)** salary: $40,500
- **(b)** inheritance: $35,000
- **(c)** alimony paid: $10,000
- **(d)** tuition paid: $5,000 (they elect to use the § 222 deduction)
- **(e)** $7,000 RE LTCG
- **(f)** $41,000 LTCG

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross Income</strong></td>
<td></td>
</tr>
<tr>
<td>Salary</td>
<td>$40,500</td>
</tr>
<tr>
<td>CGNI (§41,000 LTCG and $7,000 RE LTCG)</td>
<td>48,000</td>
</tr>
<tr>
<td><strong>Total Gross Income</strong></td>
<td>88,500</td>
</tr>
<tr>
<td><strong>Minus Adjustments</strong></td>
<td></td>
</tr>
<tr>
<td>Alimony</td>
<td>-10,000</td>
</tr>
<tr>
<td>§ 221 and § 222 MAGI</td>
<td>78,500</td>
</tr>
<tr>
<td>Minus § 222 Tuition</td>
<td>-4,000</td>
</tr>
<tr>
<td><strong>AGI</strong></td>
<td>74,500</td>
</tr>
<tr>
<td>Minus Standard Deduction</td>
<td>-10,300</td>
</tr>
<tr>
<td>Minus Exemptions</td>
<td>-6,600</td>
</tr>
<tr>
<td><strong>Equals Taxable Income</strong></td>
<td>57,600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>$57,600</td>
</tr>
<tr>
<td>Minus RE LTCG</td>
<td>-7,000</td>
</tr>
<tr>
<td>Minus NCG</td>
<td>-41,000</td>
</tr>
<tr>
<td><strong>Equals RTI</strong></td>
<td>$9,600</td>
</tr>
</tbody>
</table>

**Tax Computation**

- **Tax on 9,600 RTI** $960
- **Tax on 5,500 RE LTCG @ 10%** 550
- **Tax on 1,500 RE LTCG @ 15%** 225
- **Tax on 41,000 NCG @ 5%** 2,050

**Total Tax** $3,785
Explanation of Capital Gain Worksheet, h/o 134

(For information only.)

<table>
<thead>
<tr>
<th>Line #</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>taxable income</td>
</tr>
<tr>
<td>2</td>
<td>dividends</td>
</tr>
<tr>
<td>3</td>
<td>LTCG</td>
</tr>
<tr>
<td>4</td>
<td>NCG</td>
</tr>
<tr>
<td>5</td>
<td>amount of dividends counted as investment income to deduct investment interest</td>
</tr>
<tr>
<td>6</td>
<td>NCG (after subtracting the amount of dividends used as investment income)</td>
</tr>
<tr>
<td>7</td>
<td>RTI (taxable income minus NCG)</td>
</tr>
<tr>
<td>8</td>
<td>top of the 15% bracket</td>
</tr>
<tr>
<td>9</td>
<td>RTI</td>
</tr>
<tr>
<td>10</td>
<td>amount of NCG that falls in the 15% bracket (top of 15% bracket - RTI)</td>
</tr>
<tr>
<td>11</td>
<td>tax on NCG in 15% bracket at 5%</td>
</tr>
<tr>
<td>12</td>
<td>NCG</td>
</tr>
<tr>
<td>13</td>
<td>amount of NCG that fell in 15% bracket</td>
</tr>
<tr>
<td>14</td>
<td>balance of NCG that falls in bracket higher than 15%</td>
</tr>
<tr>
<td>15</td>
<td>tax on balance of NCG at 15% maximum rate</td>
</tr>
<tr>
<td>16</td>
<td>tax on RTI</td>
</tr>
<tr>
<td>17</td>
<td>total tax using maximum capital gains rates</td>
</tr>
<tr>
<td>18</td>
<td>tax on all income using the regular rates</td>
</tr>
<tr>
<td>19</td>
<td>tax (lower of tax using maximum capital gain rates or tax without special rates)</td>
</tr>
</tbody>
</table>
SECTION 1244 STOCK

Introduction

When a taxpayer loses money on an investment, the $3,000 limit on the deduction of capital losses adds insult to the injury. Not only did the investment fail, but the $3,000 limit on capital losses can also cause those without significant capital gains to receive little tax benefit in the year of the loss. However, if the loss is due to an investment in a small business, there may be some relief.

Code § 1244 rules apply to the original investors in the stock of small corporations. If these investors sell eligible stock at a loss, § 1244 may allow some or all of the loss to be deducted as an ordinary loss, instead of a capital loss. Since Code § 165(g) treats worthless securities as having been sold or exchanged on the last day of the year in which the stock becomes worthless, if qualified § 1244 stock becomes worthless, it may also qualify for ordinary loss treatment.

The Amount Deductible

The annual limit for ordinary loss treatment is $50,000 per year or $100,000 per year on a joint return, even if one spouse does not own any stock. If the deduction exceeds the ordinary income, the excess can be deducted from capital gains. Any loss still not deducted can be deducted against ordinary income for the prior three years and indefinitely against future ordinary income.

The Rules for § 1244 Stock

For the stock to be eligible for § 1244 treatment, the stock must be issued by a domestic C or S corporation pursuant to a § 1244 plan approved by the corporation’s directors. The stock must be common, not preferred stock and must be issued for cash or property, not services.
HOLDING PERIOD RULES

A. More Than One Year

A taxpayer must hold a capital asset more than one year for it to be considered long-term. A capital asset held exactly one year or less is a short-term asset. The holding period is determined by calendar months, not the number of days the stock has been held. For publicly traded stocks, the holding period begins the day after the stock is purchased and ends on the date of sale. An asset becomes long-term on the first counted day in the 12th month following the day of purchase.

Example 1

Moscov bought 100 shares of Nextell on 8/7/05. The holding period begins on 8/8/05 and becomes long-term on 8/8/06. If he sells the stock on 8/7/06, he will have held it exactly one year (8/8/05 through 8/7/06) and the gain or loss will be short-term.

A capital asset purchased on the last day of the month becomes long-term on the first day of the thirteenth calendar month following the month it was purchased.

Example 2

Freed purchased 200 shares of Mexican Telephone on 4/30/05. The holding period begins on 5/1/05 and the shares become long-term on 5/1/06.

B. Identification of Shares

If a taxpayer purchased several blocks of the same stock at different times and sold less than all of the shares, the FIFO (first-in-first-out) method is used to determine which stock they are selling. However, the investor can identify the shares he is selling by telling the broker at the time of the sale. Without instructions, the FIFO or average cost method will be used. (For mutual fund shares acquired at different times, most investors use the average cost.)

Example 3

Bellinger bought 100 shares of APL stock on 3/4/05 for $1,400 and another 100 shares on 5/1/05 for $1,700. On 3/8/06 she sold 100 shares for $1,500.

3/4/05 purchased 100 shares for $1,400
5/1/05 purchased 100 shares for $1,700
3/8/06 sold 100 shares for $1,500.

If she tells her broker at the time of the sale that she is selling the May shares, she will have a $200 STCL. If she does not identify the shares, the FIFO method is used and the March shares will be sold for a $100 LTCG.

C. Holding Period of Shares Acquired by Gift § 1223(2)

When the FMV of the property at the time of the gift exceeds the donor’s basis, the donee takes the donor’s basis for all gains and losses. The donee’s holding period begins when the donor’s holding period began. On the other hand, when the FMV of the property at the time of the gift is lower than the donor’s basis, the donee uses the donor’s basis and holding period if he sells the shares at a gain. For purposes of a loss, the donee must use the FMV of the shares at the time of the gift. In this case, the donee’s holding period begins on the date of the gift.
D. **Holding Period of Inherited Shares** § 1223(11)

The gain or loss on property acquired from a decedent is always long-term, no matter how long the decedent or the beneficiary held the property. If Grandpa bought stock on 2/1/06, died on 2/2/06 and grandson inherits and sells it on 2/4/06, the grandson’s gain or loss is long-term.

E. **Property Acquired from a Spouse or Incident to a Divorce** § 1041

The recipient spouse takes the holding period of the transferor spouse.

F. **Dividends** (for information only)

An investor must hold the stock for at least 60 days in the 120-day period that surround the dividend date to receive the 5% or 15% tax rate on dividends. An investor who buys stock on July 7, 2006, receives the quarterly dividend, then sells the stock on August 9, 2006 will not get LTCG treatment; the dividend will be taxed as ordinary income.

G. **Index Options and Commodity Futures Contracts** (for information only)

I will explain the reason for the following rule in class.

The general rule that unrealized appreciation is not taxed does not apply to certain index option contracts or commodity futures contracts. The Code treats these investments as if the investor sells them on the last day of the tax year. Unrealized gains and losses are considered realized at the FMV on the last day of the year. This method is known as “mark-to-market.” The investor’s basis becomes the year-end FMV. Furthermore, gains and losses from these contracts are considered 60% long-term and 40% short-term, no matter how long the investor held them.

**Example 4**

Booker purchased one NASDAQ 100 index call option (OEX) on 11/12/06 for $200. On 12/31/06, the contract was worth $1,000 and she continued to hold it. She must report an $800 gain on her 2006 return, of which $480 (60%) is LTCG and $320 (40%) is STCG. The basis is now $1,000, the FMV on 12/31/06.

On 2/1/07 she sells the contract for $700. She realizes a $300 capital loss in 2007 ($1,000 basis - $700 amount realized); $180 (60%) is LTCL and $120 (40%) is STCL.

Note that she reported an $800 gain in 2006 and a $300 loss in 2007. The net gain reported is $500, which equaled her economic loss.
HOLDING PERIOD PROBLEMS

Review the material in Chapter 5 regarding the basis of property acquired by gift and from a decedent before you begin these problems. Determine the amount and character of the gain or loss in each of the following transactions.

1. Goldberg bought 100 shares of Johnson & Johnson on 1/15/06 for $5,000 and sold them 1/15/07 for $6,000.

2. Ventrone bought 100 shares of Clark Company at $28/share on 1/31/05 and another 100 shares at $30/share on 9/10/05. He sold 150 of the shares at $50 per share on 8/1/06.

3. Steensland bought 100 shares of Emerson Radio on 6/10/05 for $5,500 and gave them to her daughter on 12/12/06 when they were worth $6,500. Her daughter sold the shares on 12/7/07 for $7,500.

4. Same as (3), but her daughter sold the shares on 12/7/07 for $4,500.

5. Daniels bought 100 shares of Enron on 7/5/00 for $7,500 and gave them to her son on 11/1/06 when they were worth $300. Her son sold them on 12/27/06 for $100.

6. Same as (6), but her son sold the shares on 12/7/06 for $400.

7. Jim’s father purchased 100 shares of HMX for $10 per share on 2/22/06. On 3/1/06, the father died when the FMV was $12 per share. Jim inherited the shares and received them from the executor on 3/12/06 when they were worth $15 per share. Jim sold the shares on 8/1/06 for $18 per share.

8. Same as (8), but the shares were worth $6 per share on 3/1/06 and he sold them for $7 per share.

9. Dan bought e-Bay stock for $14,000 in 2001. He gave them to his father on 7/5/05 when the FMV was $120,000. His father died on 3/4/06 when the FMV was $115,000 and Dan inherited the stock on 4/7/06 when it was worth $110,000. Dan sold the shares on 5/2/06 for $114,000. See § 1014(e).

10. Francine purchased GE stock for $10,000 on 8/2/05. She sold them to her husband on 2/20/06 for $7,000, the FMV on that date. Her husband sold them on 9/14/06 for $4,000. What are the tax consequences to Francine and her husband?
HOLDING PERIOD SOLUTIONS

Determine the amount and character of the gain or loss in each of the following transactions.

1. Goldberg bought 100 shares of Johnson & Johnson on 1/15/06 for $5,000 and sold them 1/15/07 for $6,000.

   $1,000 STCG. Don’t count the day of purchase, so begin counting 1/16/06. Count the day of sale, so the holding period runs from 1/16/06 - 1/15/07, exactly one year.

2. Ventrone bought 100 shares of Clark Company at $28/share on 1/31/05 and another 100 shares at $30/share on 9/10/05. He sold 150 of the shares at $50 per share on 8/1/06.

   1/31/05   B 100 @ $28
   9/10/05   B 100 @ $30
   8/1/06     S 150  @ $50

   $2,200 LTCG and $1,000 STCG

   Using the FIFO method, the first 100 shares were held long-term (2/1/05 - 8/1/06). $22 per share gain x 100 shares equals $2,200 LTCG. The second 50 shares have been held short-term. $20 per share gain x 50 shares equals $1,000 STCG.

3. Steensland bought 100 shares of Emerson Radio on 6/10/05 for $5,500 and gave them to her daughter on 12/12/06 when they were worth $6,500. Her daughter sold the shares on 12/7/07 for $7,500.

   Daughter has a $2,000 LTCG. She takes Mom’s $5,500 basis and her long-term holding period.

4. Same as (4), but her daughter sold the shares on 12/7/07 for $4,500.

   Daughter has a $1,000 LTCL. She still takes Mom’s basis and holding period when the FMV of the gift exceeds the basis on the date of the gift,

5. Daniels bought 100 shares of Enron on 7/5/00 for $7,500 and gave them to her son on 11/1/06 when they were worth $300. Her son sold them on 12/27/06 for $100.

   Son has a $200 STCL. The basis exceeds the FMV on the date of the gift so for purposes of a loss, he must use $300 FMV. Son cannot use her holding period because he cannot use her basis.

6. Same as (6), but her son sold the shares on 12/7/06 for $400.

   No gain or loss. The basis for purposes of a gain is $7,500, so there is no gain. The basis for purposes of a loss is $300, so there is no loss.
7. Taxpayer’s father purchased 100 shares of HMX for $10 per share on 2/22/06. On 3/1/06, dad died when the FMV was $12 per share. Taxpayer inherited the shares and received them from the executor on 3/12/06 when they were worth $15 per share. Taxpayer sold the shares on 8/1/06 for $18 per share.

**$600 LTCG** The basis is the $12 FMV on the date of death; gain or loss is always long-term when property is acquired from a decedent.

8. Same as (8), but the shares were worth $6 per share on 3/1/06 and he sold them for $7 per share.

**$100 LTCG.**
Note that the decedent paid $10 for the shares and taxpayer sold them for $7. There was an overall loss on the transaction, but the beneficiary had to report a gain. The decedent should have sold the shares before she died to avoid the loss being lost.

9. Dan bought e-Bay stock for $14,000 in 2001. He gave them to his father on 7/5/05 when the FMV was $120,000. His father died on 3/4/06 when the FMV was $115,000 and Dan inherited the stock on 4/7/06 when worth $110,000. Dan sold the shares on 5/2/06 for $114,000.

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>Dan paid $14,000</td>
<td></td>
</tr>
<tr>
<td>7/5/05</td>
<td>gave them to his father when FMV was $120,000</td>
<td></td>
</tr>
<tr>
<td>3/4/06</td>
<td>father died when FMV was $115,000</td>
<td></td>
</tr>
<tr>
<td>4/7/06</td>
<td>Dan inherited when worth $110,000</td>
<td></td>
</tr>
<tr>
<td>5/2/06</td>
<td>Dan sold for $114,000</td>
<td></td>
</tr>
</tbody>
</table>

Dan has **$100,000 LTCG**

He gave the shares to his father within one year of the father’s death so his basis is his father’s basis immediately before his death. His father’s basis is $14,000, the donor’s basis. This is pursuant to § 1014(e) studied in Chapter 5.

10. Francine purchased GE stock for $10,000 on 8/2/05. She sold them to her husband on 2/20/06 for $7,000, the FMV on that date. Her husband sold them on 9/14/06 for $4,000. What are the tax consequences to Francine and her husband?

Under § 1041, a spouse recognizes no gain or loss on a transfer to a spouse. The transferee spouse takes the transferor spouse’s basis and holding period.

**Francine has no gain or loss.**
Her husband’s basis is $10,000, so he has a $6,000 LTCL when he sells them for $4,000.
§ 1231 HOTCHPOT RULES

Section 1231 Property
Depreciable personal property and all real property held for more than 12 months and used in a trade or business.

Worksheet Modification
Section 1231 would require two additional columns to be added to the tax computation worksheet to the right of the LTCG(L) column.

<table>
<thead>
<tr>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>§ 1231 Main Hotchpot</th>
<th>§ 1231 Subhotchpot</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>sale of § 1231 property</td>
<td>involuntary conversions of § 1231 property</td>
</tr>
</tbody>
</table>

(1) Subhotchpot Column
Gains (in excess of recapture of depreciation) and losses from the involuntary conversion of § 1231 property are entered in the subhotchpot column.

After all transactions are entered, the column is totaled. If the column total is a gain, the total is entered in the main hotchpot column. If the column total is a loss, the loss is deducted as an ordinary loss.

(2) Main Hotchpot Column
Gains (in excess of recapture of depreciation) and losses from the sale of § 1231 property are entered in the main hotchpot column. If the column total is a gain, the gain is entered in LTCG(L) column. If column total is a loss, the loss is deducted as an ordinary loss.

Effect of § 1231
Heads taxpayer wins; tails taxpayer wins. Gains (in excess of recapture of depreciation) from the sale or involuntary conversion of § 1231 property are treated as LTCG. Losses from the sale or involuntary conversion of § 1231 property are ordinary losses, not subject to the $3,000 limit.
**Hotchpot Examples**

This example illustrates why gain (in excess of recapture) on the sale of depreciable real property is characterized as LTCG for purposes of this course, even though it is not a capital asset. Depreciable real property used in a trade or business is a § 1231 asset. If there are no losses in the § 1231 column, the gain will end up in the LTCG column.

**Facts**

Spak sells his factory for $1,400,000. Gains (in excess of recapture) from the sale of § 1231 property are entered in the main hotchpot.

<table>
<thead>
<tr>
<th>Factory Cost</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Depreciation</td>
<td>-300,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Amount Realized</th>
<th>$1,400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Basis</td>
<td>-700,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

$300,000 of the gain is attributable to depreciation and is entered in the RE LTCG column. $400,000 of the gain is § 1231 gain and is entered in the § 1231 main hotchpot column.

**Worksheet**

<table>
<thead>
<tr>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>Main Hotchpot</th>
<th>Subhotchpot</th>
</tr>
</thead>
<tbody>
<tr>
<td>300,000</td>
<td>400,000</td>
<td></td>
<td>400,000</td>
</tr>
</tbody>
</table>

The main hotchpot column total is a gain, so the gain is entered in the LTCG(L) column.

**Additional Fact**

In addition, Spak sold machinery for a $600,000 loss. The worksheet will now look like this:

**Worksheet**

<table>
<thead>
<tr>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>Main Hotchpot</th>
<th>Subhotchpot</th>
</tr>
</thead>
<tbody>
<tr>
<td>300,000</td>
<td></td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td></td>
<td>(600,000)</td>
<td></td>
<td>(200,000)</td>
</tr>
</tbody>
</table>

The $200,000 loss will be deducted as an adjustment.
SALES TO A RELATED PARTIES

Section 267 disallows a loss from a sale between related parties; § 267(c)(4) defines related family members as siblings, ancestors and lineal descendants. The buyer recognizes gain only to the extent it exceeds the seller’s disallowed loss. The following example illustrates the rule.

Myers bought Baxter stock for $30,000 in 2002 and sold it to his grandson Vic on 5/1/06 for $20,000, its fair market value.

(a) Myers realized a $10,000 loss, but Vic is a related party, so Myers cannot recognize the loss.

(b) Vic sells the stock to an unrelated person on 10/2/06 for the following amounts. Vic’s basis is $20,000, the amount he paid. However, § 267(d) provides that Vic does not have to recognize the first $10,000 of gain, the amount of Myers’ disallowed loss.

(1) $33,000: $3,000 STCG gain
Vic sold the stock for $13,000 more than he paid; §267(d) provides that he does not recognize the first $10,000 of gain. His holding period began on 5/1/06, the date he bought it, so the gain is short-term.

(2) $28,000: No gain or loss; the first $10,000 of gain is not recognized.

(3) $18,000: $2,000 STCL loss; $20,000 basis - $18,000 amount realized.

SALE TO A RELATED PARTY PROBLEMS

Problem 1
Three years ago, Dennis purchased 100 shares of GE stock for $30,000. This year Dennis sold the stock to his granddaughter Molly for $20,000, when the FMV was $20,000. May Dennis deduct the loss realized on the sale of the stock? See §§ 267(a)(1), (b)(1), and (d).

Problem 2
What is Molly’s gain or loss if she sells the stock to an unrelated third part for:

(1) $38,000
(2) $26,000
(3) $16,000

Problem 3
What result in problem (1) if Dennis sold the GE stock to Molly’s husband for $20,000? See §§ 267(a)(1), and (b)(1), and (d).
§ 1091WASH SALES

Section 1091 provides that if a taxpayer sells stock at a loss and purchases identical shares within 30 days *before or after* the date of the sale, the loss is not deductible. The disallowed loss is added to the basis of the shares purchased, § 1091(d). The holding period of the shares sold is added to the holding period of the shares purchased, § 1223(4). The purpose of the rule is to prevent taxpayers from selling stock at a loss to offset capital gains, then immediately buying it back.

**Example**

Lutz made the following transactions in Biolab stock:

- 4/3/06: bought 100 shares for $5,000
- 7/3/06: sold 100 shares for $2,200, realizing a $2,800 loss
- 8/1/06: bought 100 shares for $2,500
- 5/3/07: sold 100 shares for $8,000

Lutz *realized* a $2,800 STCL when he sold the shares in July. The loss is not recognized because he purchased 100 identical shares in August, within thirty days after selling shares at a loss. The basis of the August shares is $5,300 ($2,500 cost plus $2,800 of loss disallowed on the sale of the April shares).

When he sells the August shares the following May, he recognizes a $2,700 LTCG ($8,000 amount realized less $5,300 basis). The gain is long-term because the 3-month holding period of the shares sold in July is added to the 9-month, 2-day holding period of the August shares.

**Reconciliation**

The total cost of the Biolab shares was $7,500 ($5,000 + $2,500) and the sales proceeds totaled $10,200 ($2,200 + $8,000). The $2,700 economic gain equals the $2,700 gain realized when he sold the shares in May 2007.
NON-BUSINESS CASUALTY GAINS AND LOSS

A. Determining Loss (or Gain)

For each casualty loss, determine the loss caused by casualty, which is usually the difference between the FMV of the property before and after the casualty. The loss can never exceed the basis.

Example 1

Gehrman purchased a yacht for $40,000 that was worth $32,000 before an accident and $20,000 after. Her casualty loss is $12,000, the loss in value caused by the casualty. The $8,000 decline in value from $40,000 the $32,000 FMV immediately before the accident is a personal, nondeductible loss.

If uninsured property is destroyed or stolen, the loss for tax purposes is the lower of the FMV on the date of the loss or the basis.

Example 2

McKenzie purchased a painting for $3,000 that was worth $8,000 when stolen. The loss in value caused by the casualty was $8,000, but the casualty loss is limited to the $3,000 basis. The $5,000 of unrealized appreciation is not deductible.

Insurance Proceeds

Insurance proceeds reduce the loss caused by the casualty. If the insurance proceeds exceed the basis, the taxpayer has a casualty gain.

In example 2, if McKenzie had received $6,500 of insurance, she would have had a $3,500 casualty gain ($6,500 insurance proceeds minus $3,000 basis). Note that the painting was worth $8,000 and McKenzie received $6,500 of insurance. She might think she has a $1,500 loss, but she must report a $3,500 gain for tax purposes. If she had received $2,000 of insurance, the casualty loss would have been $1,000 ($3,000 loss minus $2,000 insurance proceeds.)
B. Tax Treatment of Casualty Losses and Gains

Casualty Losses

Enter each casualty gain and losses in the personal casualty column (the “PCC”) of the tax computation worksheet. The Code disallows the first $100 of each casualty loss, so subtract $100 from each loss before entering it in the PCC. (Make sure to put parentheses around losses in the column.) If a thief steals four uninsured items, it is one casualty and $100 is subtracted from the total of the losses. As will be explained, the holding period of casualty loss property is important so put a LT or ST next to each item as you enter it in the PCC.

Example 3

Capelli paid $22,000 for a personal car three years ago and it was worth $8,000 when it was damaged in an accident. The value of the car was $4,500 after the accident and he received $2,000 of insurance. The accident caused $3,500 of loss (FMV $8,000 before and $4,500 after the accident); the insurance proceeds reduced the loss to $1,500. Capelli enters a $1,400 loss in the PCC, identified with a LT next to it.

A laptop computer he purchased eight months ago for $2,100 was damaged beyond repair in the same accident. It was worth $900 at the time of the accident and was uninsured. He enters a $900 loss in the PCC, identified with a ST. The car and computer were damaged in the same incident, so $100 is subtracted from only one loss.

Casualty Gains

If the insurance proceeds exceed the basis of the property, the taxpayer has a casualty gain that is entered in the PCC, identified as long-term or short-term. (In the next chapter, you will learn that § 1033 permits taxpayers to defer casualty gains to the extent the taxpayer reinvests the insurance proceeds.)

Example 4

Bauer bought a ring for $3,000 three years ago and it was worth $20,000 when a thief stole it. He received $17,000 of insurance and did not buy a replacement ring, so he enters $14,000 of gain ($17,000 insurance - $3,000 basis) in the PCC, identified with a LT.

No Gain or Loss Situation

If the insurance proceeds exceed the loss, there is no casualty loss. If the proceeds do not exceed the basis of the property, there is no gain either. The result is no gain or loss.

Example 5

Waitzman paid $16,000 for a car that was worth $9,000 when stolen; he recovered $11,000 of insurance. There is no gain or loss on this transaction. The insurance reimbursed the entire $9,000 of loss caused by the casualty, so there is no casualty loss. $11,000 of insurance did not exceed his $16,000 basis, so there is no gain.

He bought the car for $16,000, “sold” it to the insurance company for $11,000, and suffered a $5,000 loss. However, the entire loss was attributable to the decline in value while he was using the car for personal purposes.
C. The Mechanics of the Personal Casualty Column (PCC)

If the PCC Total is a Loss

Total the PCC column. If the total is a loss, subtract 10% of AGI from the total and the excess, if any, is an itemized deduction.

Example 6

A thief stole rare coins worth $25,000 from Weibel that cost $10,000 several years ago. Her AGI is $87,000. Her casualty loss is $10,000, the basis of the coins, so she enters $9,900 in the PCC ($10,000 - $100). This is her only casualty gain or loss for the year, so the column total is a $9,900 loss. She subtracts $8,700 (10% of AGI) from the total, leaving $1,200 to be added to her other itemized deductions. If her total itemized deductions are less than the standard deduction, she will deduct the standard deduction and will get no tax benefit from the loss of $25,000 of coins.

If the PCC Total is a Gain

If the PCC column total is a gain, all gains and losses are treated as capital gains and losses. Add the gains and losses from the short-term assets and enter the total in the STCG(L) column of the worksheet. Add the gains and losses from the long-term assets and enter that total in the LTCG(L) column. The casualty gains and losses are netted with the other gains and losses in those columns.

Example 7

A thief stole a diamond watch (item A) worth $1,100 that Grosch purchased last month for $1,400. The watch was not insured so $1,000 of short-term casualty loss ($1,100 FMV - $100) is entered in the PCC.

The thief also took a gold necklace (item B) worth $15,000 that Grosch inherited from her aunt when it was worth $5,000. Grosch received $8,000 of insurance for the necklace. She enters $3,000 of long-term casualty gain in the PCC for the necklace ($8,000 insurance - $5,000 basis). The PCC column total is a gain so $1,000 of loss is entered in the STCG(L) column and $3,000 of gain is entered in the LTCG(L) column.
CASUALTY LOSS PROBLEMS

Do the casebook problems with the following modifications, but omit problems 1(d) and 2.

Problem 3: Carlos did not own any of the bluff that was eroded.

Problem 4: Ann bought the ring three years ago and the cost of the diamond was $4,500. She owned the car for eleven months. See §165(h)(4)(E) regarding the car loss. Answer the casebook questions first, then answer them using the following facts. Each part is unrelated to the others.

(a) She filed an insurance claim and recovered $2,500.
(b) The diamond was insured and she recovered $3,700 for it.
(c) The diamond was worth $9,000 and she recovered $6,500 of insurance proceeds.
(d) She damaged the other car in the accident and she personally paid $1,200 to the other driver for repairs. How should she treat this payment?

Do the following additional problem.

Problem 6

Three years ago Distasio bought a car for personal use for $17,000. The car was stolen this year when worth $8,000. There are no other items in the personal casualty column and her AGI is $10,000. What are the tax consequences in the following situations:

(a) She recovered $9,000 of insurance.
(b) She had “replacement value” insurance and received $19,500 to purchase a new car. The thief also stole a rare Native American artifact she purchased eight months ago for $3,000. It was worth $4,100 when stolen and she received $2,200 of insurance.
TAX COMPUTATION WORKSHEET

Problem: __________

Make sure to put parentheses around loss amounts; e.g., (1,000).

<table>
<thead>
<tr>
<th>Ordinary &amp; Portfolio</th>
<th>Dividends (NCG)</th>
<th>Passive</th>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>PCC</th>
<th>Medical</th>
<th>2% MIDs</th>
<th>Other Itemized</th>
<th>§ 221 &amp; § 222 Adjustments</th>
<th>Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>A) 92,000 Div 3,000</td>
<td>M) 3,000</td>
<td>F) (10,000) Re</td>
<td>C) (3,000) (3,000) (3,000) (3,000)</td>
<td>I) 9,697</td>
<td>(3,000) 6,697</td>
<td>B) 13,900</td>
<td>H) 600 LT</td>
<td>G) 10,000</td>
<td>E) 1,200</td>
<td>D) 6,000</td>
<td>N) 2,500</td>
</tr>
<tr>
<td>CGNI 34,697</td>
<td>←</td>
<td>←</td>
<td>←</td>
<td>← to CGNI</td>
<td>← to CGNI</td>
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<td>← to CGNI</td>
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<td></td>
</tr>
</tbody>
</table>

*(or 2,000, subj to MAGI)
TAX COMPUTATION (married couple with one child filing a joint return)

Gross Income
salary $92,000
dividends 3,000
CGNI 34,697
gross income 129,697

Adjustments
alimony $5,000
depreciation 909
total adjustments 5,909 (5,909)

MAGI for passive loss deduction 123,788
minus passive loss deduction (10,000)
MAGI for LLC and § 222 deduction 113,788 (MAGI for LLC; phased out)
minus student loan interest deduction (1,775)
§ 222MAGI 112,013
minus tuition (4,000)
AGI $108,013

Itemized Deductions

2% MIDs
investment expenses $1,200
employee business expenses 2,800
total 2% MIDs 4,000
-2% AGI (2,160)
equals deductible 2% MIDs 1,840 $1,840

Other Itemized
medical 10,000
-7½ % AGI (8,101)
deductible medical expense 1,899 1,899
real estate taxes 6,000
mortgage interest 12,000
itemized deductions before phaseout 21,739
AGI <$150,500; no phaseout 0
deductible itemized deductions 21,739 (21,739)

minus exemptions (AGI <$225,750; no phaseout) (9,900)
taxable income $76,374

Tax Computation

$76,374

minus NCG (28,000 LTCG + 3,000 div) (31,000)
minus RE LTCG (6,697)
equals RTI 38,677

$5,047
tax on 6,697 RE LTCG @ 15% 1,005
tax on 15,926 NCG @ 5% 796
tax on 15,074 NCG @ 15% 2,261
equals tax before credits 9,109

Credits
dependent care credit (600)
child tax credit (1,000)
equals tax $7,509
A. Introduction

If insurance proceeds from a casualty loss exceed the basis, the taxpayer has a casualty gain. Code § 1033 permits taxpayers to elect to defer (postpone) the gain if they use the insurance to buy replacement property within two years. The rationale for this section is that the taxpayer did not choose to dispose of the asset; it was involuntarily converted. If the taxpayer reinvests the insurance proceeds in a similar asset, the investment is essentially continued and taxing the gain at the time of the conversion would not be appropriate. Furthermore, if the taxpayer reinvested the insurance proceeds, he may not have the cash to pay the tax on the gain.

The taxpayer must recognize losses on involuntary conversions, subject to the statutory limits studied in the last chapter. ($100 is excluded from each loss and the total is deductible only to the extent it exceeds 10% of AGI.)

B. The Mechanics of § 1033

The taxpayer can elect to defer the gain to the extent the insurance proceeds are reinvested in qualifying replacement property. (All taxpayers in the course will elect to defer as much gain as permitted). Taxpayers must recognize gain to the extent the insurance proceeds exceed the cost of the replacement property. The basis of the replacement property is its cost less the gain elected to be deferred. The holding period of the new property includes the holding period of the old property.

Example 1

A fire destroyed a home O’Reilly held for investment purposes. She paid $200,000 for the property four years ago and deducted $25,000 of depreciation. She received $250,000 of insurance and purchased an investment condominium for $300,000.

Step 1. Calculate the gain or loss on the disposition

<table>
<thead>
<tr>
<th>Insurance Proceeds</th>
<th>$250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus Basis of Property Destroyed</td>
<td>- 175,000</td>
</tr>
<tr>
<td>(Cost - Depreciation)</td>
<td>(cost - depreciation)</td>
</tr>
<tr>
<td>Equals Gain Realized on the Involuntary Conversion</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

Step 2. Determine how much gain, if any, must be recognized and its character

<table>
<thead>
<tr>
<th>Insurance Proceeds</th>
<th>$250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus Cost of Replacement Property</td>
<td>- 300,000</td>
</tr>
<tr>
<td>Equals Gain that Must be Recognized</td>
<td>0</td>
</tr>
</tbody>
</table>

The cost of the replacement property exceeds the insurance proceeds, so no gain is recognized.

Step 3. Determine the basis of the replacement property

<table>
<thead>
<tr>
<th>Cost of Replacement Property</th>
<th>$300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minus Deferred Gain</td>
<td>- 75,000</td>
</tr>
<tr>
<td>Equals Basis of Replacement Property</td>
<td>$225,000</td>
</tr>
</tbody>
</table>

Step 4. Calculate the depreciation deduction for the replacement property

The depreciation deduction for residential property purchased in July is the basis multiplied by .0167. (See the depreciation handout.) O’Reilly’s deduction is $3,751 ($225,000 x .01667).
**Example 2**

Same facts as example 1, but she paid only $210,000 for the replacement condominium.

\[
\begin{align*}
\text{insurance proceeds} & \quad \$250,000 \\
\text{minus basis of property destroyed} & \quad -175,000 \\
\text{equals gain realized} & \quad \$75,000 \\
\hline
\text{insurance proceeds} & \quad \$250,000 \\
\text{minus cost of replacement property} & \quad -210,000 \\
\text{equals gain that must be recognized} & \quad \$40,000
\end{align*}
\]

$25,000 of the gain is attributable to depreciation deductions, so the first $25,000 of gain that must be recognized is characterized as RE LTCG.

\[
\begin{align*}
\text{cost of replacement property} & \quad \$230,000 \\
\text{minus gain deferred} & \quad -35,000 \quad * \\
\text{equals basis of replacement property} & \quad \$195,000
\end{align*}
\]

*She recognized $40,000 of the $75,000 gain; the $35,000 balance of the gain was deferred. The current year’s depreciation deduction on the replacement property is $3,251 ($195,000 \times .01667).*

**Example 3**

Miller bought a computer for $6,000 that he used to track his investments and deducted $3,800 of depreciation. A flood in his basement destroyed the computer when it was worth $3,300. He received $3,000 of insurance and paid $2,700 for a new computer.

\[
\begin{align*}
\text{insurance proceeds} & \quad \$3,000 \\
\text{minus basis of property destroyed} & \quad -2,200 \quad (6,000 - 3,800 \text{ depreciation}) \\
\text{equals gain realized} & \quad \$800 \\
\hline
\text{insurance proceeds} & \quad \$3,000 \\
\text{minus the cost of replacement property} & \quad -2,700 \\
\text{equals gain that must be recognized} & \quad \$300
\end{align*}
\]

The $300 recognized gain is ordinary income because of recapture of depreciation.

\[
\begin{align*}
\text{cost of replacement property} & \quad \$2,700 \\
\text{minus gain deferred} & \quad -500 \quad ($800 \text{ gain} - \$300 \text{ recognized}) \\
\text{equals basis of replacement property} & \quad \$2,200
\end{align*}
\]

The computer is listed property used less than 50% for business (investing is not a trade or business). First-year expensing is not permitted and the computer must be depreciated using straight-line over a 12-year period. One-half year of depreciation is allowed in the year of acquisition. The depreciation deduction is $92 ($2,200 basis ÷ 12 year recovery period = $183 depreciation per year x 50% for the first year).
C. Replacement Property Must be Similar or Related in Service or Use

To qualify for nonrecognition, the taxpayer must reinvest the proceeds in property “similar or related in service or use.” If the taxpayer uses the insurance proceeds to invest in a different kind of property (or to pocket some insurance proceeds), gain must be recognized on the amount not properly reinvested. The following Revenue Ruling illustrates how the IRS interprets “similar or related in service or use.”

REVENUE RULING 76-319

The taxpayer, a domestic corporation, was engaged in the operation of a recreational bowling center prior to the center’s complete destruction by fire on June 30, 1974. The bowling center had consisted of bowling alleys, together with a lounge area and a bar. The center was fully insured against loss by fire. As a result of such insurance coverage the taxpayer received insurance proceeds in compensation for the destruction of the bowling center in an amount that exceeded the taxpayer’s basis in the property. On its Federal income tax return for 1974, the taxpayer elected to defer recognition of the gain under the provisions of section 1033 of the Code.

Within the period specified in section 1033(a)(3)(B) of the Code, the taxpayer invested the insurance proceeds in a new recreational billiard center. In addition to billiard tables, this center includes a lounge area, and a bar. The specific question is whether the recreational billiard center (replacement property) is “similar or related in service or use” to the recreational bowling center (involuntarily converted property) within the meaning of section 1033(a)(3)(A) of the Code.

Rev. Rul. 64-237, 1964-2 C.B. 319, states that, with respect to an owner-user, property is not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties are closely similar. In the instant case, the involuntarily converted property was a bowling center that consisted of bowling alleys together with a lounge area and a bar. The replacement property consists of a billiards center that included billiard tables, a lounge area, and a bar. The physical characteristics of the replacement property are not closely similar to those of the converted property since bowling alleys and bowling equipment are not closely similar to billiard tables and billiard equipment.

Accordingly, in the instant case, the billiard center is not similar or related in service or use to the bowling center within the meaning of section 1033(a)(3)(A) of the Code.

PROBLEM

On September 1, 2003, Lewis paid $250,000 for a condo in Florida for investment purposes. A hurricane in February 2006 destroyed the building and he recovered $260,000 of insurance. He purchased a condominium for investment in Arizona for $235,000 on November 3, 2006. Determine all of the tax consequences for 2006. (Refer to the depreciation handout to calculate the depreciation deductions and the character of the gain on the sale of depreciable property.)
Solution to § 1033 Problem

On September 1, 2003, Lewis paid $250,000 for a condo in Florida for investment purposes. A hurricane in February 2006 destroyed the building and he recovered $260,000 of insurance. He purchased a condominium for investment in Arizona for $235,000 on November 3, 2006. Determine all of the tax consequences for 2006. (Refer to the depreciation handout to calculate the depreciation deductions and the character of the gain on the sale of depreciable property.)

Step 1. Determine the gain or loss on the disposition

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Total Depreciation</th>
<th>Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>2,653</td>
<td>2,653</td>
<td>250,000</td>
</tr>
<tr>
<td>2004</td>
<td>9,090</td>
<td>9,090</td>
<td>231,910</td>
</tr>
<tr>
<td>2005</td>
<td>9,090</td>
<td>9,090</td>
<td>222,820</td>
</tr>
<tr>
<td>2006</td>
<td>1,136</td>
<td>21,969</td>
<td>228,031</td>
</tr>
</tbody>
</table>

Insurance proceeds: $260,000

Cost of replacement property: $235,000

Gain that must be recognized: $25,000

$21,969 of the gain is attributable to depreciation deductions and is characterized as RE LTCG. The $3,031 balance of the gain is LTCG.

Step 2. Determine how much gain, if any, must be recognized and its character

<table>
<thead>
<tr>
<th>Insurance proceeds: $260,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of replacement property: $235,000</td>
</tr>
<tr>
<td>Gain that must be recognized: $25,000</td>
</tr>
</tbody>
</table>

$21,969 of the gain is attributable to depreciation deductions and is characterized as RE LTCG. The $3,031 balance of the gain is LTCG.

Step 3. Determine the basis of the replacement property:

| Cost of replacement property: $235,000 |
| Minus gain deferred: -6,969 |
| Basis of replacement condominium: $228,031 |

Step 4. Determine the depreciation deduction on the replacement property.

2006 depreciation on the Arizona condo: $228,031 x .00455 = $1,038

2006 Tax Consequences (amounts entered on the worksheet)

- $1,136 of depreciation on the Florida condo is entered in the adjustment column
- $21,969 of the recognized gain is entered in the RE LTCG column
- $3,031 of the recognized gain is entered in the LTCG(L) column
- $1,038 of depreciation on the Arizona condominium is entered in the adjustment column
LIKE KIND (STARKER) EXCHANGES § 1031

A. General Rule

When a taxpayer exchanges business or investment property for “like kind” property, § 1031 provides that no gain or loss may be recognized. Section 1031 exchanges are commonly known as “Starker” exchanges. This provision is not elective and does not apply to stock, bonds, securities or inventory. The holding period of the old property is added to the holding period of the like kind property received in the exchange. Generally, all real property is considered like kind with all other real property. For example, an apartment building exchanged for a vacant lot is considered a like kind exchange.

The rationale for § 1031 is an investor is merely continuing the investment in a changed form when property is exchanged for similar property. Since little or no cash is exchanged, it is not an appropriate time to tax the gain. Many real estate investors take advantage of this provision and defer gain by exchanging their property, instead of selling it. There are many companies that arrange these exchanges for investors. (Google “Starker Exchange” and see how many links are listed.)

When the taxpayer exchanges one property for another, the taxpayer must determine:

1. the amount and character of gain or loss realized on the property being disposed of
2. the gain or loss that must be recognized
3. the basis of the new property acquired

B. Exchanges Solely for Like Kind

If the exchange is solely for like kind property (i.e., the taxpayer gives or received no other property in the exchange), no gain or loss is recognized by either taxpayer. The basis of the property received in the exchange is the same as the basis of the property exchanged.

Example 1

Brill exchanged his $1,000,000 vacant lot purchased in 1998 for Rudstein’s apartment building worth $1,000,000 he bought in 1995. Brill’s basis in the lot is $1,300,000 and Rudstein’s basis in the apartment building is $750,000.

<table>
<thead>
<tr>
<th></th>
<th>Brill</th>
<th>Rudstein</th>
</tr>
</thead>
<tbody>
<tr>
<td>lot</td>
<td>$1,000,000</td>
<td>apartment building $1,000,000</td>
</tr>
<tr>
<td>basis</td>
<td>1,300,000</td>
<td>basis</td>
</tr>
</tbody>
</table>

Brill realized a $300,000 loss on the disposition of the lot ($1 million amount realized minus $1,300,000 basis of property he exchanged) but no loss is recognized under § 1031. The basis of the building he received is $1,300,000, the same as the basis of the property he exchanged. The holding period of the apartment building is long-term. (Brill should have sold the lot and deducted the $300,000 loss instead of exchanging it.) Rudstein realized a $250,000 gain on the disposition of the apartment building, but none is recognized. The basis of the lot he received is $750,000.

C. Basis of Property Acquired

The basis rules are complicated, but can be summarized as follows. The basis of all property (not cash) received in the exchange equals the basis of all property and cash transferred, less cash received, plus gain recognized, less loss recognized on the non-like kind property being disposed of. The total basis is allocated to the property received in the transaction.
D. **Exchanges Involving Cash or Other Property (“Boot”)**

Two properties involved in an exchange will seldom have the same fair market value. In those situations, one party must pay cash or give other property to even things up. For example, Leslie and Wright agree to exchange rental condos they own. Leslie’s condo is worth $225,000 and Wright’s is worth $220,000. Wright agrees to pay $5,000 in cash “to boot” so the FMV of the properties and cash exchanged will be equal. “Boot” is cash or non-like kind property transferred in the exchange to even things up. The tax rules regarding boot are as follows:

(1) The taxpayer **transferring boot** in the exchange must recognize the gain or loss on the disposition of the boot. The boot given is being sold, not exchanged.

(2) The taxpayer **receiving boot** in the exchange must recognize gain on the like kind property being exchanged up to the value of the boot received. Boot received in an exchange is considered the same as cash received.

(3) No **loss** is recognized on the like kind property whether or not the taxpayer receives boot.

**Example 2**

Connolly exchanged her farm worth $200,000 for Warner’s lot worth $215,000. In addition, Connolly gave Warner $15,000 of BTI stock purchased two years ago for $12,000. Connolly paid $160,000 for the farm and Warner’s paid $170,000 for the lot.

<table>
<thead>
<tr>
<th></th>
<th>Connolly</th>
<th>Warner</th>
</tr>
</thead>
<tbody>
<tr>
<td>farm</td>
<td>$200,000</td>
<td>$215,000</td>
</tr>
<tr>
<td>basis</td>
<td>160,000</td>
<td>170,000</td>
</tr>
<tr>
<td>BTI stock</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>basis</td>
<td>12,000</td>
<td></td>
</tr>
</tbody>
</table>

Connolly realized a $40,000 gain on the farm and a $3,000 gain on the stock. The gain on the farm is not recognized because she received only like kind property for it. The gain on the stock is recognized because gain or loss is always recognized on the boot being exchanged. The character of the non-like kind property determines the character of the gain or loss recognized. Connolly recognizes a $3,000 LTCG on the stock.

Warner realized a $45,000 LTCG gain on the exchange of the lot. She must recognize $15,000 of the gain because she received $15,000 of boot (non-like kind property) in the transaction. Warner reports a $15,000 long-term capital gain on the exchange of the lot.

E. **Uncle Will Get You Eventually, Unless . . .**

If the taxpayer keeps exchanging property for like kind property, the gains keep deferring. When the last property is eventually sold, the taxpayer will pay tax on all of the deferred gain. One way to deprive Uncle of the tax on the appreciation is to keep exchanging property until death. When the taxpayer dies, the heirs’ basis will be stepped up to the fair market value on the date of death.
CASH and ACCRUAL METHODS of ACCOUNTING

The cash and accrual methods are the two basic methods of accounting for tax purposes.

A. CASH METHOD

All individual taxpayers use the cash method.

Receipts

Income is taxed in the year that cash, property or services are received. Cash includes checks received during the year, even at a New Year’s Eve party at 11:59 p.m. on December 31. A cash method taxpayer reports income received in advance in the year she receives it. If a patient pays her psychiatrist in December for six months in advance, the doctor must report all of the income in the year he received it.

Constructive Receipt

The regulations state that a taxpayer receives income when it is “credited to his account, set apart for him, or otherwise made available.” A cash method taxpayer who has control over the receipt of income must report it, whether or not she has physical possession of it. For example, if a client offers to pay her lawyer a $5,000 fee on December 31, 2006 and the lawyer tells her to hold the check a couple of days until 2007, the lawyer must report the income in 2006. The lawyer wanted to postpone paying tax on the income for twelve months perhaps because he will be in a lower tax bracket in 2007.

Deferred Compensation

An important exception to the constructive receipt doctrine is a deferred compensation arrangement where the taxpayer contracts in advance to receive income in later years. If an athlete contracts with his team to receive $10 million of his signing bonus in 2010 (plus interest), instead of in the current year, the $10 million is “deferred compensation.” He will not pay tax on it until he receives it in 2010. This is a “non-qualified” deferred compensation arrangement that differs from “qualified” plans (IRAs, 401(k)s, that we will study later) in an important way. The deferred compensation in a non-qualified plan is subject to the claims of the employer’s creditors. The employee risks losing the deferred compensation if the employer has financial problems. Qualified pension and profit-sharing are not subject to the claims of the employer’s creditors.

Payments

Cash method taxpayers deduct expenses in the year they pay them. The tax law follows the “mailbox” rule: an amount is considered paid in the year the taxpayer mails a check or signs a credit card charge. On December 31, 2006, Smith charged a $2,000 contribution to the United Way on his Discover card. He deducts the contribution in 2006, although he does not pay the Discover card bill until 2007.
Expenses Paid in Advance

Expenses paid in advance must be deducted in the years for which the payments are made. Jones pays his psychiatrist for a year in advance on December 31, 2006, to aggregate his medical expenses into 2006 so they will exceed 7½% of AGI. The amount he paid for 2007 is not deductible until 2007. As noted above, however, the doctor must report all of the income in 2006 because they must report income received in advance in the year received.

B. ACCRUAL METHOD

Income: Under the accrual method, taxpayers report income in the year they earn it, even if they have not received payment. An attorney using the accrual method reports $10,000 of income in 2006 if she completes the work and sends the bill in 2006, although she does not receive the payment until 2007.

Expenses: Expenses are deducted in the year they are incurred, not when they are paid. If the attorney does not pay the December 2006 rent until January 2007, she still deducts the expense in 2006, the year in which she incurred the expense. Most large businesses use the accrual method and they are required to use the accrual method if they have substantial inventory.

Problems

Samson received tax advice from accountant Miller and paid the $500 fee by signing a Visa charge on December 29, 2006. Miller’s bank credited his account for $460 on January 2, 2007. $40 was subtracted by Visa for the transaction fee. Samson received the Visa bill on January 21, 2007 and paid it February 7, 2007.

1. Assuming both taxpayers use the cash method:
   (a) How and when should Miller report the income?

   (b) May Samson deduct the legal fee? If so, under which Code section and in what year?

2. Answer the same questions, but assume both taxpayers use the accrual method.
THE TAX COMPUTATION

A. TAX RATES

Filing Status

There are four tax rates: joint, single, head of household, and married filing separately.

1. Married Couples § 1(a)

Heterosexual couples who are married on the last day of the year use the joint tax rate schedule. If one spouse dies during the year, the surviving spouse is considered married that for that year. Same-sex couples who are legally married under state law are considered unmarried for purposes of all Federal laws, including the tax law pursuant to The Defense of Marriage Act enacted in 1996.

Surviving Spouse § 2(a)

A surviving spouse is a taxpayer whose spouse died during either of the two taxable years before the current year and who maintains a household with a child or a stepchild. The taxpayer must pay more than one-half the cost of maintaining the household. A surviving spouse uses the joint rate tax schedules.

2. Head of Household § 2(b)

A head of household is an unmarried individual (who is not a surviving spouse) who maintains a household with a dependent as defined in § 151. We will study § 151 shortly, but the dependent does not have to be a child or a stepchild. The taxpayer must pay more than one-half of the cost of maintaining the household. These taxpayers use the head of household tax rate schedules.

3. Unmarried Individuals § 1(c)

An unmarried individual is a taxpayer who is not married and is not a surviving spouse or head of household. These taxpayers use the single tax rate schedules.

4. Married Taxpayers Filing Separate Returns § 1(d)

A married couple can elect to file separate returns and use the “married filing separately” tax rate schedules. The tax rates in § 1(d) for these taxpayers are the highest of the four categories; couples filing separately usually pay more tax than if they had filed jointly. Some couples file separately because they keep their finances separate or are living apart. In a few situations, filing separately may save tax for the couple. For example, if one spouse has large medical expenses or casualty losses, that spouse’s AGI will be lower and more of those expenses will be deductible.

If one spouse itemizes their deductions, the other spouse must also itemize. That prevents one spouse from deducting all of the itemized deductions and the other spouse taking a standard deduction. Furthermore, some tax benefits, like the passive loss RE deduction and the child care credit are not available to married couples filing separate returns.

Inflation Adjustments

The tax brackets, exemption deduction, standard deduction, and phaseout floors are adjusted for inflation each. (Compare the 2006 and 2007 amounts on h/o 1.) Before this change, taxpayers who received a salary increase that just kept pace with inflation moved into higher and higher tax brackets, although the extra salary did not increase their purchasing power.
The Marriage Penalty (and Bonus)

The “marriage penalty” occurs when a married couple pays more tax than they would have paid if they were single. Andy and Amy are single and live together; they each have taxable income of $125,000. They will each pay $29,332 of federal income tax, or $58,664 combined. If they were married, their tax on a joint return with $250,000 of taxable income would be $62,482. The additional $3,818 of tax is their “marriage penalty.” This “penalty” is highest when the couple have approximately equal income.

Until 1948, the Code taxed all taxpayers under a single set of rates. In 1930, the Supreme Court held that earnings and other income of each spouse in community property states was taxable one-half to each spouse. Under the single progressive rate table then in effect, income splitting between community property spouses gave them a major tax advantage over couples living in common law states. A movement began in common law states to adopt the community property system to give their residents the benefit of reduced income taxes that resulted from income splitting. In 1948 Congress responded by enacting a joint rate table that treated a married couple’s income as if each earned one-half of it.

In 1969, Congress reduced the rates for single taxpayers for the following reason, as explained by the Joint Committee on Taxation:

Under prior law, the tax rates imposed on single persons were quite heavy relative to those imposed on married couples at the same income level; at some income levels a single person’s tax was as much as 42.1 percent higher than the tax paid on a joint return with the same amount of taxable income. The Congress believed that some difference between the rate of tax paid by single persons and joint returns was appropriate to reflect the additional living expenses of married taxpayers but that the prior law differential of as much as 42% could not be justified on this basis. The Act provides a new lower rate schedule for single persons effective in 1971.

This reduction in rates caused the tax disparity now known as the marriage penalty. In 2001, Congress enacted some provisions to reduce the marriage penalty for middle and lower income taxpayers. The 15% bracket for married taxpayers was increased to double the single taxpayer amount. (Note on h/o 1 that in 2006, the 15% bracket ends at $30,650 for single taxpayers and at $61,300 for joint returns, twice the single amount.) In addition, the standard deduction for married taxpayers was also increased to double the single taxpayer amount.

The following example shows that a middle-income couple does get a reduction in the marriage penalty, but the higher-income couple still pays a substantial marriage penalty. Mr. and Ms. High each earned $150,000 and the Moderates each earned $50,000. The following table shows the 2006 tax for these two couples filing a joint return and if they were single. Note the exemption for the Highs is partially phased out.

<table>
<thead>
<tr>
<th></th>
<th>The Highs</th>
<th></th>
<th>The Moderates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Single</td>
<td>Joint</td>
<td>Single</td>
</tr>
<tr>
<td>gross income &amp; AGI</td>
<td>$150,000</td>
<td>$300,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>minus standard deduction</td>
<td>- 5,150</td>
<td>- 10,300</td>
<td>- 5,150</td>
</tr>
<tr>
<td>minus exemptions</td>
<td>- 3,300</td>
<td>- 3,960</td>
<td>- 3,300</td>
</tr>
<tr>
<td>taxable income</td>
<td>$141,550</td>
<td>$285,740</td>
<td>$41,550</td>
</tr>
<tr>
<td>tax</td>
<td>$33,966</td>
<td>$74,276</td>
<td>$6,945</td>
</tr>
<tr>
<td>x 2</td>
<td></td>
<td>$67,932</td>
<td></td>
</tr>
<tr>
<td>marriage penalty</td>
<td></td>
<td>$6,344</td>
<td></td>
</tr>
</tbody>
</table>

This example shows that a middle-income couple does get a reduction in the marriage penalty, but the higher-income couple still pays a substantial marriage penalty.
If the Highs had been single, they would each pay tax of $33,966, making the total $67,932. Their marriage penalty is $6,344, the difference between the tax as a married couple and the tax for two single taxpayers. The Moderates pay the same tax whether married or single, so they have no marriage penalty. These computations assume that they used the standard deduction instead of itemizing. The Highs probably would have itemized their deductions, which would increase marriage penalty even more because they would not be taking advantage of the increased standard deduction for married couples.

**Marriage Bonus**

Many married taxpayers receive a “marriage bonus” and don’t complain about it. Alice has taxable income of $250,000; her husband Ralph has no income. Her 2006 tax would be $69,092 at single rates. However their 2006 tax at joint rates is $62,482, a marriage bonus of $6,610.

**Indirect Rate Increases (Phaseouts)**

Congress indirectly increased the tax rates of upper-income taxpayers by phasing out personal exemptions, itemized deductions, passive losses, educational incentives and other tax benefits based on the taxpayer’s AGI. These phaseout provisions broaden the tax base and generate revenue.

When a taxpayer’s AGI reaches the phaseout range of a particular benefit, the effective rate of additional income in the phaseout range increases dramatically. For example, Jerry is a single taxpayer with an AGI of $45,000 and paid $10,000 for law school tuition. The LLC begins phasing out at $45,000 of AGI, so he is entitled to the full $2,000 Lifetime Learning credit. However, if he had earned $2,000 more, 20% of the LLC is phased out at $47,000 of AGI, reducing the credit to $1,600. The extra $2,000 he earned cost him $400 of LLC so he paid an extra 20% tax on it ($400 tax ÷ $2,000 extra income). He is in the 25% tax bracket, so the extra $2,000 of income was taxed at an effective rate of 45% (25% regular tax plus 20% extra tax attributable to the LLC phaseout).

Most phaseouts occur over a range of AGI, such as itemized deductions, exemptions, and the LLC. However, the § 222 tuition deduction is not phased out gradually; it ends abruptly when the taxpayer’s AGI exceeds the maximum by just one dollar. A single taxpayer loses $2,000 of the deduction if her AGI is $65,001. The extra dollar of income cost the taxpayer $500 of tax ($2,000 of lost deduction costs a taxpayer in the 25% bracket $500 in tax).

**Tax Tables**

The IRS publishes a tax table in the Form 1040 instructions that taxpayers with less than $100,000 of taxable income are required to use to calculate their tax. The table provides the tax based on the taxable income and filing status without any calculations. Taxpayers must use the table for ease of administration even if the tax rate schedules on h/o 1 may provide a slightly lower tax.

**Maximum Tax Rates**

The maximum tax rates and the number of tax brackets have varied widely through the years. In 1948, there were twenty-five separate tax brackets; in 1986 there were only two: 15% and 28%. There are six tax brackets in 2006, ranging from 10% to 35%. A table showing the history of tax rates dating from the first income tax appears on the next page.
B. THE STANDARD DEDUCTION

Code § 63(c) provides a standard deduction that taxpayers can deduct if their itemized deductions are less than the standard deduction amount. The 2006 inflation-adjusted standard deduction amounts as shown on h/o 1 are as follows. The 2007 amounts are in parentheses.

<table>
<thead>
<tr>
<th>Category</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>joint and surviving spouse</td>
<td>$10,300</td>
<td>($10,700)</td>
</tr>
<tr>
<td>head of household</td>
<td>7,550</td>
<td>(7,850)</td>
</tr>
<tr>
<td>single and married filing separately</td>
<td>5,150</td>
<td>(5,350)</td>
</tr>
</tbody>
</table>

Dependent on Another’s Return § 63(c) (5)

The standard deduction for a dependent on another’s tax return is the greater of (a) $850 or (b) earned income plus $300. The standard deduction for a dependent cannot exceed the $5,150 ($5,350) maximum deduction for a single taxpayer in 2006.

Extra Standard Deduction for Over 64 and/or Blind § 63(f)

A single taxpayer over 64 and/or blind may deduct an extra $1,250 ($1,300) of standard deduction for each condition. On joint returns, the amount for each condition is $1,000 ($1,050). The standard deduction for a married couple over 64 is $12,300 ($12,800), including the extra standard deduction. Taxpayers who itemize their deductions receive no benefit from the increased standard deduction.

The Standard Deduction Reduces the Tax Benefit of Itemized Deductions

As the standard deduction increases for inflation each year, fewer taxpayers itemize their deductions, which makes tax returns easier for the IRS to administer. The standard deduction effectively reduces the tax benefit of itemized deductions as discussed on h/o 115. When comparing the cost of purchasing a home with renting an apartment, taxpayers often calculate tax savings based on the full amount of the mortgage interest and real estate taxes they will pay. However, these deductions only reduce taxable income to the extent they exceed the $10,300 standard deduction for married couples in 2006 ($10,700 in 2007).

Example

A married couple rents an apartment and have $3,500 of itemized deductions. They will deduct the $10,300 standard deduction, which will save them $2,575 of tax in the 25% bracket. If they buy a condo and pay $12,000 of mortgage interest and real estate taxes, their itemized deductions will total $15,500. This will save them $3,875 ($15,500 x 25%), which is only $1,300 more than they saved with the standard deduction. They might have estimated that $12,000 of interest and taxes would save them $3,000 of tax in the 25% bracket, but the savings was only $1,300.
STANDARD DEDUCTION PROBLEMS

1. Tom, a single taxpayer, is in the 15% bracket and has $5,500 of itemized deductions. How much tax will the itemized deductions effectively save him?

2. Barbara is 67, blind, and married to 64-year-old Leo; she has $12,000 of itemized deductions. Should she itemize or take the standard deduction?

3. How much is the standard deduction for Terry, a 14-year-old dependent on his parents’ return if he has the following amounts of income in 2006?
   (a) no earned income and $500 of interest income;
   (b) $1,000 of earned income and $5,000 of interest income;
   (c) $6,000 of earned income and $1,000 of interest income.

Solutions

1. The itemized deductions will save him only $53 of tax. $5,500 of itemized deductions minus the $5,150 standard deduction equals a reduction in taxable income of $350 x 15% = $53.

2. She should take the standard deduction of $12,300 ($10,300 basic standard deduction on a joint return plus $1,000 of extra standard deduction for her age and blindness).

3. (a) $850
   (b) $1,300 ($1,000 of earned income plus $300)
   (c) $5,150 (the maximum for a single individual)
C. ITEMIZED DEDUCTIONS

Taxpayers subtract the greater of itemized deductions or the standard deduction from AGI. Code § 68(a)(1) phases itemized deductions out by 2% of the amount by which AGI exceeds the $150,500 “applicable amount” in 2006. The same amount applies to both single and joint tax returns and is adjusted for inflation each year. The phaseout applies to total itemized deductions after other limitations have been subtracted, such as 2% of AGI from MIDs.

From 2001 to 2005, the phaseout percentage was 3% of AGI above the applicable amount. The percentage was reduced to 2% for 2006-7, will be reduced to 1% for 2008-9, and will be eliminated in 2010. The reduction of the phaseout percentage reduces the tax of higher-income taxpayers because it allows them to deduct more of their itemized deductions.

Code § 68(e) provides that medical expenses, investment interest and casualty losses are not phased out, presumably because they are already subject to AGI limits. However, 2% MIDs are subject to phaseout. In addition, § 68(a)(2) provides that no more than 80% of the taxpayer’s itemized deductions can be phased out in a year. These phaseout exceptions will not be tested on the exam.

Example

The Cravins are a married couple with AGI of $160,000 and $12,000 of itemized deductions. $190 of their itemized deductions are phased out, calculated as follows: $160,000 AGI - $150,500 = $9,500 x 2% = $190.

Itemized Deduction Problem

Jennifer, a single taxpayer, had AGI of $200,000 and the following itemized deductions: $25,000 real estate tax, $15,000 mortgage interest and $10,000 of charitable contributions. How much of her itemized deductions are deductible?

Solution

$200,000 AGI - 150,500 applicable amount = 49,500 x 2% = $990 phased out
$50,000 itemized deductions - $990 phased out = $49,010 deductible
D. EXEMPTIONS

1. In General

A taxpayer is entitled to a $3,300 exemption deduction for himself, his spouse, and qualified dependents in 2006. The deduction is adjusted for inflation each year. Code § 152 defines two categories of qualifying dependents: qualifying children and qualifying relatives, and sets forth the following requirements for dependency.

Qualifying Child § 152(c)

(A) relationship test: the individual must be the child of the taxpayer (or a descendant of a child) or the taxpayer’s sibling (or descendant of a sibling);

(B) residence test: the child must live in the taxpayer’s residence for more than half the year;

(C) age test: the child must be under 19, or under 24 if the child is a full-time student;

(D) support test: the child must not have provided over one-half of his or her own support during the year. Note that the test does not require the taxpayer to have provided over one-half of the qualifying child’s support.

A 24-year child is too old to be a qualifying child but may be a qualifying relative. The requirements for a qualifying relative are as follows:

Qualifying Relative § 152(d)

(A) relationship test: See § 152(d)(2) for the individuals who are qualifying relatives. Section 162(d)(2)(H) provides that an unrelated individual who lives in the taxpayer’s home for the taxable year qualifies as a dependent. Other qualifying relatives do not have to live in the taxpayer’s residence.

(B) gross income test: the qualifying relative’s gross income must be less than the exemption amount, which is $3,300 in 2006;

(C) support test: the taxpayer must provide over one-half of the relative’s support in the year.

Note that there is no gross income test for a qualifying child and no age or residence test for a qualifying relative.

2. Phaseout

Code § 151(d)(3) phases the exemption out beginning at AGI of $225,750 on a joint return and $150,500 on a single return in 2006. These amounts are adjusted for inflation each year. If the taxpayer’s AGI exceeds those amounts, use h/o 1A to determine the amount of the deduction.

3. No Exemption Deduction for a Qualifying Dependent § 151(d)(2)

A taxpayer cannot deduct a personal exemption if he or she qualifies as a dependent on another taxpayer’s return. A child who qualifies as a dependent on his parents’ return cannot take a deduction for a personal exemption on her return. This is true even if her parents waived the exemption to permit him to use the Lifetime Learning credit, as explained next.
4. Waiving a Child’s Exemption for § 25A Education Credits

Code § 25A(g)(3) provides that a taxpayer who is a dependent on another’s return may not take the Hope or Lifetime Learning credits. However, if parents waive the exemption, this will permit the child to use the Hope or Lifetime Learning credit. This will save tax if the parents are phased out of the education credits and perhaps part of the exemption deductions. On a joint return, the § 25A educational credits are phased out between $90,000 and $110,000 of AGI and the exemptions begin phasing out at $225,750 of AGI. Remember that a child may not claim an exemption even if her parents waive the exemption because the child “qualifies” as a dependent on her parents’ return.

Example

The Kellys have AGI of $400,000 and pay $30,000 for college tuition for Amy, their 20-year-old daughter who is a junior at State. They are in the 35% tax bracket. Amy works part-time and received interest and dividends from securities her parents gave her. Her taxable income is $15,000 and her tax is $1,873.

For the Kellys, the LLC and the § 222 deduction are fully phased out and two-thirds of the exemption deduction is phased out. If they waive their exemption, Amy can use the LLC on her return, which will reduce her tax to zero. Her parents could have deducted $1,100 for the exemption at $400,000 of AGI. Waiving the exemption will cost them $385 of tax ($1,100 x 35%), but the family will save $1,488 ($1,873 saved by Amy minus the $385 cost to her parents). Amy qualifies as a dependent on her parents’ return, so she cannot claim an exemption on her return.

This strategy only works if the student has taxable income and tax from which to subtract the LLC. If the student doesn’t have taxable income, the parents can give their child appreciated securities which the child can sell to generate taxable income. The $2,000 of LLC will eliminate $15,850 of taxable income at the child’s tax rate, calculated as follows:

\[
\begin{align*}
\text{first} & \ 7,550 \times 10\% \ & = \ & 755 \\
\text{next} & \ 8,300 \times 15\% \ & = \ & 1,245 \\
\text{total} & \ 15,850 \ & = \ & 2,000 \\
\end{align*}
\]
EXEMPTION PROBLEMS

1. The Thompsons have two qualifying children and AGI of $238,250. How much is their exemption deduction? (Note that their AGI does not exceed $238,250.)

2(a) The Goldbergs’ son Roger is 22, a full-time college student, and earned $4,000. May the Goldbergs claim Roger as a dependent? May Roger claim himself?

(b) Same facts as (a), but Roger is 25.

3. Barbara and Ron are single and have lived together for two years. Ron is a law student who earned $3,000 in 2006. Barbara provides more than one-half of his support. Can Barbara take an exemption deduction for Ron?

4. Margaret and Charlie are negotiating their divorce settlement. Charlie will retain custody of their two children and Margaret will pay him $80,000 per year of alimony. Margaret’s AGI will be $275,000 after deducting alimony, which puts her in the 33% bracket for single taxpayers. Charlie’s AGI is $80,000 and he will be in the 25% bracket. Would you advise Charlie to waive the exemption deduction for the children to Margaret?
EXEMPTION PROBLEM SOLUTIONS

1. The Thompsons have two qualifying children and AGI of $238,250. How much is their exemption deduction? (Note that their AGI does not exceed $238,250.)

$12,320 from h/o 1A

2(a) The Goldbergs’ son Roger is 22, a full-time college student, and earned $4,000. May the Goldbergs claim Roger as a dependent? May Roger claim himself?

They may claim Roger because there is no gross income test for a qualifying child, § 152(c). Roger may not claim himself.

2(b) Same facts as (a), but Roger is 25.

Roger is not a qualifying child because he is over 23. He not a qualifying relative because he earns more than the $3,300 exemption amount. The Goldbergs cannot deduct an exemption for him so Roger can now claim a personal exemption on his own return.

3. Barbara and Ron are single and have lived together for two years. Ron is a law student who earned $3,000 in 2006. Barbara provides more than one-half of his support. Can Barbara take an exemption deduction for Ron?

Yes; Ron is a qualifying relative so Barbara may claim an exemption deduction for him.

4. Margaret and Charlie are negotiating their divorce settlement. Charlie will retain custody of their two children and Margaret will pay him $80,000 per year of alimony. Margaret’s AGI will be $275,000 after deducting alimony, which puts her in the 33% bracket for single taxpayers. Charlie’s AGI is $80,000 and he will be in the 25% bracket. Would you advise Charlie to waive the exemption deduction for the children to Margaret?

No. At $275,000 of AGI, Margaret can deduct $1,100 for each child, which will save her $726 of tax in the 33% bracket ($2,200 x 33%).

Charlie can deduct $6,600 for the two children that will save him $1,650 of tax ($6,600 x 25%). His tax savings exceeds hers so he should not waive the exemptions to her. If Margaret’s tax savings exceeded Charlie’s, he might consider waiving the exemption deduction to her if she agreed to split the tax savings with him.
E. TAX CREDITS

Credits reduce the tax dollar for dollar; a $100 credit saves a taxpayer $100 whether she is in the 15% or 35% bracket. Most tax credits are nonrefundable; if the credit exceeds the tax due, the balance of the credit disappears. For example, if the Lifetime Learning credit exceeds the tax, the balance of the credit is lost. If a refundable tax credit exceeds the tax, either a portion or all of the credit is refunded to the taxpayer.

The Code contains a myriad of credits enacted for a variety of reasons. Skim the partial listing of credits on the next page. You will be responsible for the following credits on the final exam. We have already studied the first and second credits listed; explanations of the other credits follow.

§ 25A Hope and Lifetime Learning credits (nonrefundable); chapter 18
§ 21 dependent care credit (nonrefundable); chapter 19
§ 24 child tax credit (partially refundable)
§ 32 EITC (earned income tax credit) (fully refundable)
withholding tax and estimated tax payments (fully refundable)

Order of Credits

Credits are subtracted from the tax in the following order:

(1) education and dependent care credits; if they exceed the tax, the remainder is lost.
(2) child tax credit; partially refundable
(3) EITC; fully refunded to the extent it exceeds the remaining tax.
(4) Withholding and estimated tax payments are subtracted last and are fully refunded to the extent they exceed remaining tax.

ADOPTION CREDIT and EXCLUSION (for information only)

Code § 23 (not in your selected statutes) provides a tax credit for qualified expenses to adopt a child under 19. The 2007 credit is 100% of the first $11,390 of qualified adoption expenses the taxpayer spent. If the taxpayer adopts a child with special needs as defined in the Code, the credit is $11,390, even if the taxpayer spends less than that amount. The credit is phased out from AGI $170,820 to $210,820, adjusted for inflation.

Code § 137 excludes adoption expenses reimbursed by an employer; the exclusion and the phaseout are the same as for the credit.
### SELECTED CREDITS AGAINST THE TAX

#### § Subpart A – Nonrefundable Personal Credits

- **21** Expenses for household and dependent care services necessary for gainful employment
- **22** Credit for the elderly and the permanently and totally disabled
- **23** Adoption expenses
- **24** Child tax credit
- **25** Interest on certain home mortgages
- **25A** Hope and Lifetime Learning credits
- **25B** Elective deferrals and IRA contributions by certain individuals
- **26** Limitation based on tax liability; definition of tax liability

#### Subpart B – Other Credits

- **29** Credit for producing fuel from a nonconventional source
- **30** Credit for qualified electric vehicles
- **30B** Alternative Motor Vehicle (hybrid and electric cars)

#### Subpart C – Refundable Credits

- **31** Tax withheld on wages
- **32** Earned income (EITC)
- **33** Tax withheld at source on nonresident aliens and foreign corporations
- **34** Certain uses of gasoline and special fuels
- **35** Overpayments of tax

#### Subpart D – Business Related Credits

- **38** General business credit
- **39** Carryback and carryforward of unused credits
- **40** Alcohol used as a fuel
- **41** Credit for increasing research activities
- **42** Low-income housing credit
- **43** Enhanced oil recovery credit
- **44** Expenditures to provide access to disabled individuals
- **45** Electricity produced from certain renewable resources
- **45A** Indian employment credit
- **45C** Clinical testing expenses for certain drugs for rare diseases or conditions
- **45E** Small employer pension plan startup costs
- **45F** Employer-provided child care credit
The child tax credit is $1,000 for each child under 17.

The Credit is Partially Refundable

If the CTC exceeds the tax owed, the excess is refunded to the extent of 15% of the taxpayer’s earned income over $11,300 ($11,750 in 2007, for your information). The CTC is subtracted after the nonrefundable dependent care and education credits are subtracted from the tax. The following examples illustrate the computation.

**Example 1**

Joey and Laura have three children under 17. Their 2006 gross income is $30,000, consisting of $28,000 of salary and $2,000 of interest income. Their taxable income is $3,200 (30,000 - $10,300 standard deduction - $16,500 for five exemptions) and their tax is $320 before credits.

Their CTC is $3,000 ($1,000 x 3 children). $320 of the credit reduces their tax to zero, leaving $2,680 of excess credit. $2,505 of the excess will be refunded, calculated as follows: $28,000 earned income - $11,300 = $16,700 x 15% = $2,505. The $175 balance of the excess credit is lost.

**Phaseout**

Low-income taxpayers may get a refund of the excess credit, as discussed in example 1. For higher-income taxpayers, the CTC is phased out by $50 for each $1,000 (or fraction of $1,000) that AGI exceeds $110,000 on a joint return and $75,000 on a single return.

**Example 2**

The Engerts have two children under 17 and their AGI is $125,900. Their CTC is $2,000 ($1,000 x 2 children) before phaseout. Their AGI is $16,000 more than $110,000 (rounded up to the nearest $1,000), so $800 of the CTC is phased out (16 x $50). The $1,200 balance of the CTC reduces their tax.

**PROBLEMS**

**Problem 1**

The Layfers have two children under 17. They earned $27,000 in salary, received $1,000 of interest income, and will use the standard deduction. Calculate their tax and the amount of their refund.

**Problem 2**

The Smiths have one child under 17, AGI of $118,500, and will use the standard deduction. $13,000 was withheld from their salaries. Calculate their tax and the balance due.
**CHILD TAX CREDIT SOLUTIONS**

**Problem 1** The Layfers have two children under 17. They earned $27,000 in salary, received $1,000 of interest income, and will use the standard deduction. Calculate their tax and the amount of their refund.

\[
\begin{align*}
\text{salaries} & \quad $27,000 \\
\text{interest income} & \quad + 1,000 \\
\text{equals AGI} & \quad 28,000 \\
\text{minus standard deduction} & \quad - 10,300 \\
\text{minus 4 exemptions} & \quad - 13,200 \\
\text{equals taxable income} & \quad $4,500
\end{align*}
\]

The tax is $450 before credits.

(b) The CTC is $2,000 ($1,000 x 2). $2,000 CTC - $450 tax = $1,550 excess credit.

The amount of credit refunded is earned income - $11,300 x 15%.

$27,000 * earned income (salaries) - $11,300 = $15,700 x 15% = $2,355.

All of the $1,550 of excess credit will be refunded; the amount refunded cannot exceed the $1,550 excess credit.

**Problem 2** The Smiths have one child under 17, AGI of $118,500, and will use the standard deduction. $13,000 was withheld from their salaries. Calculate their tax and the balance due.

\[
\begin{align*}
\text{AGI} & \quad $118,500 \\
\text{minus standard deduction} & \quad - 10,300 \\
\text{minus 3 exemptions} & \quad - 9,900 \\
\text{equals taxable income} & \quad $ 98,300
\end{align*}
\]

The tax is $17,690 before credits.

**Phaseout of CTC**

Their CTC is $1,000 before phaseout. It is phased out by $50 per $1,000 (or fraction of a thousand) that AGI exceeds $110,000. $118,500 AGI - $110,000 = $8,500 rounded up to $9,000.

$50 x 9 = $450 phased out. $1,000 credit - $450 phased out = $550 CTC remaining

\[
\begin{align*}
\text{tax before credit} & \quad $17,690 \\
\text{minus CTC} & \quad - 550 \\
\text{minus tax withheld} & \quad - 13,000 \\
\text{equals balance due} & \quad $4,140
\end{align*}
\]
EARNED INCOME TAX CREDIT (EITC) § 32

The earned income tax credit (EITC) is a federal subsidy for low-income working taxpayers.

Eligibility § 32(c)(1)

The taxpayer must either have a qualifying child under 19 or a full-time student under 24, or the taxpayer must be at least 25. In addition, the taxpayer must not be a dependent of another taxpayer, and not have more than $2,900 of investment income in 2007.

Amount of Credit

The Code classifies taxpayers in one of three categories: (1) no qualifying children (2) one qualifying child, and (3) two or more qualifying children. The credit is calculated by multiplying the taxpayer’s earned income (up to a maximum amount for each category) by a specified percentage. Earned income is salary and wages, but does not include interest, dividends or other receipts. The credit begins phasing out as the greater of AGI or earned income exceeds a specified amount. Note: you will not have to compute the EITC on the exam, so this handout uses 2007 amounts.

The maximum credit in 2007 is $4,716 for taxpayers with two children; $2,853 for one child and $428 with no children. The credit is phased out by 21% of the amount that AGI exceeds $17,390 for married couples with at least one child and is completely phased at $39,783 of AGI for married couples with two or more children.

A married couple with two children with earned income of $17,390 will have no income tax liability. They will be entitled to receive a check for the maximum $4,716 EITC after they file their 2007 tax return in 2008. They can elect to receive advance payments of the EITC during 2007. If they make this election, they will receive a check for $393 each month in 2007 ($4,716 ÷ 12).

In addition, the couple will receive a partial refund of the child tax credit, as discussed in the previous handout. Their CTC is $2,000; they have no income tax, so their excess credit is $2,000. $17,390 of earned income - $11,300 = $6,090 x 15% = $914 of CTC they will be entitled to receive. Add that to the 2007 maximum EITC of $4,716 and the total federal subsidy of EITC and excess CTC credit is $5,630.

The Credit is Fully Refundable

The credit is fully refundable; if it exceeds the tax, the excess is refunded to the taxpayer. The EITC is subtracted from the tax after the education credits, dependent care and child tax credits. If the taxpayer’s income is too low to have any income tax liability because of the standard deduction and personal exemptions, the taxpayer will receive the full credit.
WITHHOLDING TAX and ESTIMATED TAX PAYMENTS

A. 2007 FICA and Medicare Tax Rates

**Employee and employer:** Each pays 6.2% on the first $98,700 of salary for FICA, and 1.45% of all salary for Medicare tax. The total paid by each is 7.65% on the first $98,700 of salary and 1.45% of all salary above that amount.

**Self-employed individuals** essentially pay both the employer and employee’s share of both taxes. So a self-employed taxpayer pays 15.3% self-employment tax on the first $98,700 of income earned and 2.9% of income earned above $98,700.

B. Estimated Tax and Withholding Tax

Employers withhold income tax from their employees’ pay and remit it to the government; the employee gets a credit against his or her tax liability for the amount withheld. If the amount withheld exceeds the employee’s tax liability, the excess is refunded.

Self-employed taxpayers (or taxpayers with a significant amount of unearned income on which no tax is withheld, such as interest and dividends) must estimate how much income and self-employment tax they will owe. If it will exceed $1,000, they must make quarterly estimated tax payments to avoid paying interest and an underpayment penalty. Estimated payments for 2007 are due on April 15, June 15, September 15, 2007 and January 15, 2008.

**Example 1**

Wolf, a single, independent contractor estimates she will earn $15,000 in 2006. She paid $24,000 of law school tuition so the Lifetime Learning credit will eliminate her income tax liability. However, self-employed individuals must pay self-employment tax of 15.3% on every dollar of net income. She will owe $2,295 of self-employment tax ($15,000 x 15.3%). To avoid penalties and interest, she should make quarterly estimated tax payments of $574 ($2,295 ÷ 4) by the dates specified above, beginning April 15, 2007.

C. How Much Estimated Tax is Required?

The taxpayer can use one of two methods to make estimated payments and avoid interest and penalties. If they use either method and make the required payments, no interest or penalty will be assessed, no matter how much tax they will end up owing at the end of the year. These are “safe harbor” provisions.

1. **90% of the current year’s tax**

Taxpayers who can estimate their 2007 income with reasonable certainty should make estimated payments that total at least 90% of the 2006 income and self-employment tax. If the total of estimated payments is less than 90% of the actual 2007 tax, a penalty will be imposed.

2. **100% or 110% of the previous year’s tax**

Many taxpayers, especially those who are self-employed, will not know by April 15 of the tax year how much income they will make by the end of the year. These taxpayers can make estimated payments based on their 2006 tax, which they know by April 15, the due date of the first installment of estimated tax. If the 2006 AGI is less than $150,000, the taxpayer must make estimated payments equal to 100% of the 2006 tax. If the 2005 AGI exceeded $150,000, the estimated payments must equal 110% of the 2006 tax. No penalty will be imposed if the taxpayer makes the requisite payments no matter how much tax they ultimately owe for 2007.
Example 2
Abbott, a self-employed lawyer, paid income and self-employment taxes of $70,000 in 2006 and her 2006 AGI exceeded $150,000. She should make estimated payments totaling $77,000 ($70,000 x 110%). The quarterly payments will be $19,250, one-fourth of $77,000. If during the year it looks as if she will owe more than $77,000 of taxes, she does not have to increase her quarterly payments. Payments based on 110% of the 2006 tax are sufficient to avoid any penalties.

Penalties

Underpayment
The IRS will assess a penalty if the estimated and withholding tax payments are less than 90% of the final tax, unless the amount due is less than $1,000. The penalty is an additional (nondeductible) tax equal to the interest that would accrue on the underpayment from the due date until the taxpayer pays it.

Late Payment
If the tax is not paid by the April 15, 2008 filing deadline, the taxpayer will owe a penalty equal to ½% per month of the tax due. In addition, the IRS will charge interest on the underpayment. The tax must be paid on April 15, even if the taxpayer applies for an extension to file the tax return.

Late Filing
The penalty for filing a return late is 4.5% of the amount owed per month up to a maximum of 22.5%. The IRS can waive the penalty for hardship, casualty or other unusual circumstances.

Refunds
Taxpayers often like to get refunds, which they consider a windfall or found money. However, a large tax refund is really an interest-free loan made to the U.S. Treasury. Uncle does not repay the loan until the taxpayer files the 2007 return in 2008. If a taxpayer expects a large refund, she should consider reducing the amount being withheld or the estimated payments.
G. THE KIDDIE TAX § 1(g)

History

A popular technique to save income tax before 1986 was to give children stocks and bonds so the interest and dividends would be taxed at the kids’ low rates. Interest, dividends and capital gains are “unearned income.” To reduce the effectiveness of this income-shifting strategy, Congress enacted the “kiddie tax,” which taxes the unearned income of a child under 14 in excess of $1,700 at the parents’ tax rate. The $1,700 is adjusted for inflation each year. The rule applies even if the child paid for the securities from the child’s own earnings and did not receive them from her parents.

It became apparent to Congress that wealthy taxpayers were still saving a bundle by shifting investment income to children over 17. Congress got into the act again, and beginning in 2006 the rule can apply until children reach age 18. Well, the ink was barely dry on the law that changed the age from 14 to 18, and now Congress changed the law again. The Small Business and Work Opportunity Tax act of 2007” extended the kiddie tax up to the age of 24 for children whose earned income is less than one-half of their own support. The kiddie tax will only apply to children from ages 19 through 23 if they are full time students; this change becomes effective in 2008.

One of the important consequences is that when the kiddie tax applies, the children cannot use the 5% or zero percent rate on capital gains; their capital gains will be taxed at 15%.

Computation of the Kiddie Tax

The amount of the child’s unearned income over $1,700 is called net unearned income (NUI). For example, if a child has $2,000 of interest income, the NUI is $300 ($2,000 - $1,700). The following steps will illustrate how to calculate the kiddie tax, which for 2007 applies to kids under 19.

Step 1: Total the gross income and subtract the child’s standard deduction from AGI. (Remember that the 2006 standard deduction for a dependent on another’s return is the greater of $850 or earned income plus $300, up to the $5,150 maximum). A dependent on another’s return is not entitled to a personal exemption.

Step 2: Determine the NUI (unearned income - $1,700) and subtract it from the child’s taxable income. Compute the income tax on the income remaining after subtracting NUI.

Step 3: Compute the tax on NUI at the parents’ rate.

Step 4: The child’s tax is the total of the tax in step 2 and step 3.

Example

15-year-old Tami earned $2,000 and had interest income of $2,900. Her parents’ taxable income is $315,000, which puts them in the 35% bracket.

Step 1: Tami’s gross income is $4,900 and her standard deduction is $2,300 ($2,000 earned income plus $300). Her taxable income is $2,600. She has no exemption deduction because she can be claimed as a dependent on her parents’ return.

Step 2: NUI is $1,200 ($2,900 unearned income - $1,700). Subtract $1,200 NUI from her $2,600 taxable income and the result is $1,400 of taxable income taxed at Tami’s rate. The tax on $1,400 is $140.

Step 3: The $1,200 NUI is taxed at her parents’ 35% rate; the tax is $420.

Step 4: Tami’s total tax is $560 ($140 taxed at her rate plus $420 taxed at her parents’ rate).
KIDDIE TAX PROBLEMS

The taxpayers in the following problems are children under 18 and qualify as dependents on their parent’s tax returns. Calculate their 2006 tax. Remember that dependents are not entitled to an exemption and their standard deduction is limited to the greater of earned income plus $300 or $850 in 2006.

1. Staci earned $450 babysitting and had $2,200 of dividend income. Her parents have taxable income of $200,000.

2. Brenda earned $12,000 as a model and had $2,500 of interest income. Her parents’ taxable income is $70,000.

SOLUTIONS

Problem 1. Staci earned $450 babysitting and had $2,200 of dividend income. Her parents have taxable income of $200,000.

Staci’s taxable income is $1,800 ($2,650 gross income - $850 standard deduction).
NUI is $500 ($2,200 unearned income - $1,700).
$1,800 taxable income - $500 NUI = $1,300 taxed at Staci’s rate; the tax is $130.
$500 NUI x 15% maximum rate for dividends at parents’ rate = $75.
Staci’s tax is $205 ($130 at her rate and $75 at her parents’ rate).

Problem 2. Brenda earned $12,000 as a model and had $2,500 of interest income. Her parents’ taxable income is $70,000.

Brenda’s taxable income is $9,350 ($14,500 gross - $5,150 maximum standard deduction).
NUI equals $800 ($2,500 - $1,700).
$9,350 taxable income - $800 NUI = $8,550 taxed at Brenda’s rate; the tax is $905.*
$800 NUI x 25% parents’ rate = $200
the total tax is $1,105

*Note: make sure to use the tax schedule or the tax calculator to calculate the tax on the child’s income if taxable income exceeds the 10% bracket. The 10% bracket ends at taxable income of $7,550 in 2006.
H. THE ALTERNATIVE MINIMUM TAX § 55

**Computation** (This is for your information only; it will not be tested on the exam.)

1. Begin with taxable income computed the regular way.

2. Add deductions not deductible for AMT purposes, including, but not limited to:
   a. personal exemptions
   b. 2% MIDs
   c. state and local taxes
   d. standard deduction
   e. some medical expenses (deductible only to the extent they exceed 10% of AGI)
   f. home equity interest
   g. interest on certain tax-exempt bonds

3. The result is **Alternative Minimum Taxable Income (AMTI)**

4. Subtract the **AMT exemption**

   The 2003 Tax Act increased the AMT exemption from $45,000 to $58,000 on joint returns and from $33,750 to $40,250 for single taxpayers for 2003-2005. The higher amounts expired in 2005. The House and Senate passed different versions of an extension of the higher amounts. After many months of debate and compromise, Congress enacted the Tax Increase Prevention and Reconciliation Act in May 2006, which increased the exemption amounts for 2006 only. The new exemptions amounts are $62,550 on joint returns and $42,500 on single returns.

   The exemption is phased out by 25% of the amount that AMTI exceeds $150,000 on a joint return or $112,500 on a single return. For example, if a single taxpayer has AMTI of $160,000, it exceeds $112,500 by $47,500. The $42,500 exemption is reduced by $11,875 ($47,500 x 25%) to $30,625.

5. The result is the **Taxable Excess**

6. The tax on the taxable excess is 26% on the first $175,000 and 28% on the balance.

   Net Capital Gain: Net capital gain (LTCG and dividends) is taxed at the 15% maximum rate. However NCG is included in AMTI, which may reduce or eliminate the AMT exemption.

7. Subtract credits: most credits are deductible from the AMT.

8. The AMT is the excess of the tax computed for AMT purposes over the tax computed the regular way. The AMT is added to the regular tax to determine the total tax.
**Example of the AMT Computation**

The Smiths have three children under 17, AGI of $150,000 and $48,000 of itemized deductions (after the phaseout), including $40,000 of state and local taxes and interest on a home equity loan.

**Regular Tax Computation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGI</td>
<td>$150,000</td>
</tr>
<tr>
<td>minus itemized deductions</td>
<td>- 48,000</td>
</tr>
<tr>
<td>minus 5 exemptions</td>
<td>- 16,500</td>
</tr>
<tr>
<td>taxable income</td>
<td>$85,500</td>
</tr>
<tr>
<td>tax:</td>
<td>$14,490</td>
</tr>
<tr>
<td>- child tax credit*</td>
<td>- 1,000</td>
</tr>
<tr>
<td><strong>$13,490 regular tax</strong></td>
<td></td>
</tr>
</tbody>
</table>

* $3,000 credit before phaseout; $150,000 AGI - $110,000 = 40 thousand; $50 x 40 = $2,000 phased out.

**AMT Computation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>taxable income from above</td>
<td>$85,500</td>
</tr>
<tr>
<td>add state and local income taxes and home equity interest</td>
<td>40,000</td>
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<tr>
<td>add personal exemptions (not deductible for AMT purposes)</td>
<td>16,500</td>
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<tr>
<td>equals alternative minimum taxable income (AMTI)</td>
<td>$142,000</td>
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<tr>
<td>minus AMT exemption</td>
<td>- 62,550</td>
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<tr>
<td>Taxable Excess (TE)</td>
<td>$79,450</td>
</tr>
<tr>
<td>AMT tax: $79,450 TE x 26% = $20,657 - $1,000 child tax credit = $19,657 AMT</td>
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</tbody>
</table>

The AMT is $6,167 ($19,657 AMT tax - $13,490 regular tax). Their total tax is $19,657 ($13,490 regular tax plus $6,167 AMT).

Using the same tax facts, the AMT was $20,840 in 2005, and would have been $24,220 if the pre-2003 $45,000 exemption had been applicable. The extra $17,550 of exemption will save $4,563 of AMT tax for taxpayers in the 26% AMT bracket and $4,914 for those in the 28% AMT bracket.

**AMT Planning**

A self-employed taxpayer who may be subject to the AMT should do some forecasting near the end of the year. If she estimates that the AMT will apply in the current year, but not in the next year, and that her tax rate next year will be higher than 28%, she can reduce the impact of the AMT. She should try to accelerate income into the current year and delay paying deductible amounts to the next year, as explained in the following example.

**Example**

In early December 2006, Kelly, a physician, determined that she will be subject to the 26% AMT rate in 2006, but not in 2007, when her marginal regular tax rate will be 35%. She immediately sent statements to her patients to attempt to receive the income in 2006. She will pay tax at the 26% AMT rate on income she receives in 2006, but at 35% on income she receives in 2007. Kelly saves 9% on income successfully accelerated to 2006. (To the extent her Taxable Excess exceeds $175,000, the AMT rate will be 28%, so the savings will be 2% less.) In addition, she postpones mailing her $10,000 contribution to Chicago-Kent until 2007. The $10,000 deduction will save her $3,500 of tax in the 35% bracket in 2007, but only $2,600 or $2,800 of tax at the AMT rates in 2006.
Top Ten Things that Cause AMT Liability

from Tax Guide for Investors at www.fairmark.com

This page provides a list of items that can cause (or contribute to) liability under the alternative minimum tax. The list isn't complete — there are other items that can contribute to AMT liability. Based on our experience, the items described below are likely to affect more people than other items. By the way, if you count more than 10 items below, just consider it a bonus.

Exemptions

Believe it or not, exemptions contribute to AMT liability. The exemptions you claim for yourself, your spouse and your dependents are not allowed when calculating alternative minimum tax. It's pretty rare (though not impossible) to see a tax return where someone had to pay AMT solely because of their exemptions, but the more exemptions you claim, the more likely it is that you'll have AMT liability when all is said and done.

Standard Deduction

Some 70% of American taxpayers claim the standard deduction (rather than itemizing). The standard deduction isn't allowed under the AMT. Usually this isn't a problem because the AMT generally hits people with higher incomes, and these people are more likely to claim itemized deductions. Yet it's worth noting that a deduction that's so widely used can contribute to AMT liability.

State and Local Taxes

If you itemize, there's a good chance you claim a deduction for state and local tax, including property tax and state income tax. For 2004 and 2005, you can claim a deduction for sales tax if you don't claim a deduction for state or local income tax. These deductions are not allowed under the AMT. If you live in a place where state and local taxes are high, you're more likely to be subject to the alternative minimum tax.

Interest on Second Mortgages

The AMT allows a deduction for interest on mortgage borrowings used to buy, build or improve your home. If you borrowed against your home for some other purpose, the interest deduction isn't allowed under the alternative minimum tax.

Medical Expenses

The AMT allows a medical expense deduction, but it's more limited than the deduction under the regular income tax. If you claim an itemized deduction for medical expenses, part or all of it will be disallowed when you calculate your alternative minimum tax.

Miscellaneous Itemized Deductions

Certain itemized deductions are available if your total in this general category is more than 2% of your adjusted gross income. Among the items here are unreimbursed employee expenses, tax preparation fees, and many investment expenses. You can't deduct these items under the AMT, though. If you claim a large number in this area, you could end up paying alternative minimum tax.
Various Credits

Many of the credits that are allowed when you calculate your regular income tax aren't allowed when you calculate your AMT. The more credits you claim, the more likely it is that you'll end up paying alternative minimum tax. Fortunately, Congress has extended relief for the "personal credits" in recent years.

Incentive Stock Options

Generally you don't report anything on your regular income tax at the time you exercise an incentive stock option. But you have to report income for purposes of the AMT. Exercising a large incentive stock option is almost certain to cause you to pay alternative minimum tax.

Long-Term Capital Gains

Long-term capital gains receive the same preferential rate under the AMT as they do under the regular income tax. In theory, they shouldn't cause you to pay alternative minimum tax. In practice, it's possible to be stuck with AMT liability because of a large capital gain. The reasons are a little complicated, but mainly have to do with the fact that a large capital gain reduces or eliminates the AMT exemption amount, which is designed to protect low-income taxpayers from having to pay alternative minimum tax.

Tax-Exempt Interest

Interest that's exempt from the regular income tax may or may not be exempt from the AMT. It depends on complicated rules that are fully understood only by bond lawyers. Bonds that aren't exempt from AMT pay a slightly higher rate of interest to compensate for the fact that they aren't fully tax-exempt. If you invest in bonds that aren't exempt under the alternative minimum tax, you're a candidate for AMT liability.

Many mutual funds that provide exempt interest invest at least some of their money in bonds that aren't exempt under the AMT, to get a higher rate of interest. Their annual statement tells you how much of the exempt interest dividend you received during the year is taxable under the alternative minimum tax.

Tax Shelters

The Tax Reform Act of 1986 severely curtailed the ability to reduce income tax through tax shelters. Yet there are still some legitimate ways of reducing tax liability through investments in certain types of partnership or limited liability company arrangements involving such activities as oil and gas drilling. The AMT provides reduced tax benefits for these activities. You should always explore the alternative minimum tax consequences (among other things) before investing in a tax shelter.
I. STEPS TO COMPUTE THE 2006 TAX
(A tax computation worksheet is on the next page.)

1. For each transaction, write an explanation and show the computation in your notes or in the blue book. Enter the tax consequences in the appropriate column(s) of the tax worksheet.

2. After you have entered all transactions on the worksheet, total the PCC column. If the total is a gain, enter each item in the column in the LT or ST capital columns. If the PCC total is a loss, do nothing at this point and determine the amount deductible at step 7 below.

3. Total the STCG(L), RE LTCG and LTCG(L) columns and net gains and losses. If gains exceed losses, the result is CGNI and is entered in the ordinary income column. If losses exceed gains, enter the lesser of the loss or $3,000 in the regular adjustment column. Total the rest of the columns, but enter the dividends total in the ordinary income column before totaling that column.

4. On a computation page, subtract the regular adjustments total from the ordinary income total. The result is MAGI for the passive loss deduction.

5. If the passive column total is a gain, add the gain to the MAGI. If the total is a loss, determine the amount deductible under the $25,000 RE exception and subtract it from MAGI. The result is § 221 MAGI for the student loan interest deduction.

6. Calculate the student loan interest deduction and subtract it from the § 221 MAGI; the result is § 222 MAGI for the tuition deduction. Subtract the tuition deduction to arrive at AGI.

7. Subtract 2% of AGI from 2% MIDs, 7½% of AGI from medical expenses, and 10% of AGI from the PCC loss total. Total the deductible itemized deductions.

8. If AGI exceeds $150,500 (for both single and married taxpayers), calculate the itemized deduction phaseout by subtracting $150,500 from AGI and multiplying the result by 2%. Subtract the phaseout from total itemized deductions to get deductible itemized deductions.

9. Subtract the greater of the standard deduction or deductible itemized deductions from AGI.

10. If AGI does not exceed $150,500 on a single return or $225,750 on a joint return, multiply the number of exemptions by $3,300. If AGI exceeds those amounts, use h/o 1A to determine the exemption deduction. Subtract the exemption deduction from AGI to get taxable income.

11. Subtract NCG (LTCG from the LTCG worksheet column and dividends from the dividend column) and RE LTCG from taxable income to get RTI. Compute the tax as follows:

   RTI is taxed at regular rates;
   RE LTCG is taxed at 10% or 15% if in those brackets and at 25% if in a higher bracket;
   NCG is taxed at 5% if in the 10% or 15% brackets and at 15% if in a higher bracket;
   Total the tax on RTI, RE LTCG and NCG to get the tax before credits.

12. Subtract credits in the following order to arrive at the final tax:

   1. Hope Scholarship credit or Lifetime Learning credit
   2. dependent care credit
   3. child tax credit (partially refundable if it exceeds the tax)
   4. earned income tax credit (fully refundable if it exceeds the remaining tax)
   5. withholding tax and estimated payments (fully refundable if it exceeds the remaining tax)
TAX COMPUTATION WORKSHEET

Problem: _____________

Make sure to put parentheses around loss amounts; e.g., (1,000).

<table>
<thead>
<tr>
<th>Ordinary &amp; Portfolio (NCG)</th>
<th>Dividends</th>
<th>Passive</th>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>PCC</th>
<th>Medical</th>
<th>2% MIDs</th>
<th>Other Itemized</th>
<th>§ 221 &amp; § 222 Adjustments</th>
<th>Regular Adjustments</th>
</tr>
</thead>
</table>
Example 1

Hoffman, a single taxpayer, earned $220,000 as a doctor and received $14,000 of dividends. He paid $50,000 of alimony to his former wife, $7,000 for state income tax and $3,200 to his church. He computes his tax as follows:

\[
\begin{align*}
gross income & \\
\text{salary} & $220,000 \\
\text{dividends} & 14,000 \\
gross income & $234,000 \\
\text{minus adjustments (alimony)} & -50,000 \\
equals AGI & 184,000 \\
\text{itemized deductions} & \\
\text{state income tax} & $7,000 \\
\text{contributions} & 3,200 \\
\text{itemized deductions before phaseout} & 10,200 \\
\text{minus itemized deduction phaseout*} & -670 \\
deductible itemized deductions & 9,530 \\
\text{minus exemption (h/o 1A)} & -2,684 \\
taxable income & 171,786 \\
tax computation & \\
taxable income & 171,786 \\
\text{minus NCG (dividends)} & -14,000 \\
equals RTI & 157,786 \\
tax on RTI at regular rates & $38,661 \\
tax on $14,000 NCG @ 15\% & 2,100 \\
tax & $40,761 \\
\end{align*}
\]

*itemized deduction phaseout: $184,000 AGI - 150,500 = $33,500 x 2% = $670
Example 2

The Witherspoons have two children, ages 15 and 11. Their salaries totaled $102,000, they received $2,000 of dividends and had a $5,000 long-term capital gain. They paid $25,000 of mortgage interest on their condo and he paid $400 of bar association dues.

gross income
salaries $102,000
CGNI ($5,000 LTCG) 5,000
dividends 2,000
total gross income and AGI 109,000

itemized deductions
mortgage interest 25,000
2% MIDs
dues 400
minus 2% of AGI - 2,180
none are deductible 0

total itemized deductions (no phaseout) 25,000 - 25,000
minus exemptions @ $3,300 each - 13,200
taxable income $70,800

tax computation
taxable income $70,800
- NCG (LTCG and dividends) - 7,000
RTI $63,800
tax on RTI $9,065 *
tax on $7,000 NCG @ 15% 1,050
tax before credits 10,115
minus child tax credit - 2,000
tax $8,115

*You will have to use h/o 1 to calculate the tax on the exam. The h/o 1 calculation is as follows:

$63,800 RTI on a joint return is more than $61,300 but less than $123,700
the tax is $8,440 + 25% of RTI over $61,300
$63,800 RTI - $61,300 = $2,500 x 25% = $625
The tax is $9,065 ($8,440 + $625).
J. REVIEW PROBLEMS

Problem 1
The Lees have two children, 19-year-old Lisa, a full-time student, and 14-year-old Sam. They have the following income and expenditures in 2006; compute their 2006 tax.

(a) earned $111,000 in salaries  
(b) received $2,000 in interest on a savings account  
(c) received a $20,000 gift from a favorite aunt  
(d) paid $12,000 for rent during the year  
(e) donated $5,000 to Chicago-Kent

Problem 2
The Clooneys have two children, ages 5 and 9. They have the following income and expenditures in 2006; compute their 2006 tax and determine the balance due or their refund.

(a) earned $240,000 in salaries  
(b) $20,000 LTCG  
(c) received a $50,000 inheritance  
(d) paid $30,000 of alimony to one of their former spouses  
(e) paid $26,000 of interest on their home mortgage  
(f) $50,000 of income tax was withheld from their paychecks (a credit against the tax).

Problem 3
Note: This is a comprehensive problem that will take some time to do. As you do a few more practice comprehensive problems, they will take less time. The Steps handout will guide you through the computation.

Weisz, a single taxpayer, is an executive with a health insurance company. She has the following income and expenditures in 2006; compute her 2006 tax.

(A) $152,000 salary  
(B) $2,000 dividends  
(C) $1 million inheritance  
(D) $10,000 loss from a real estate activity in which she actively participates; $7,000 is at risk  
(E) $12,000 alimony was paid to his former wife  
(F) $8,000 dental expenses  
(G) $5,000 mortgage interest  
(H) $1,500 professional association dues  
(I) $2,000 investment expenses  
(J) $2,250 real estate tax  
(K) $6,000 of insurance gain on valuable art they owned for 7 years that was stolen
SOLUTIONS TO REVIEW PROBLEMS

Problem 1
The Lees have two children, 19-year-old Lisa and 14-year-old Sam. They have the following income and expenditures in 2006; compute their 2006 tax.
   (a) earned salaries of $111,000
   (b) received $2,000 of interest on a savings account
   (c) received a $20,000 gift from a favorite aunt
   (d) paid $12,000 for rent during the year
   (e) donated $5,000 to Chicago-Kent

Solution
The gift is excluded under § 102 and the rent is a nondeductible personal expense.

gross income
   salaries $  111,000
   interest  2,000
   gross income and AGI 113,000
minus standard deduction (exceeds $5,000 itemized) - 10,300
minus 4 exemptions (no phaseout, see h/o 1A) - 13,200
equals taxable income (RTI) $   89,500

tax computation
tax on RTI $15,490
minus child tax credit* - 850
税 $14,640

*Lisa is not under 17 and doesn’t qualify for the credit, so the CTC is $1,000 before phaseout.
$113,000 AGI - $110,000 = 3 thousand; $50 x 3 = $150 phased out. $1,000 CTC - $150 phased out = $850 credit remaining.
Problem 2
The Clooneys have two children, ages 5 and 9. They have the following income and expenditures in 2006; compute their 2006 tax and determine the balance due or their refund.

(a) earned $240,000 in salaries
(b) $20,000 LTCG
(c) received a $50,000 inheritance
(d) paid $30,000 of alimony to one of their former spouses
(e) paid $26,000 of interest on their home mortgage

Solution
The inheritance is excluded from their income under § 102.

gross income
    salaries       $  240,000
    CGNI           20,000
    gross income   260,000
minus adjustments
    alimony        - 30,000
equals AGI & MAGI 230,000
minus itemized deductions:
    mortgage interest 26,000
    minus itemized deduction phaseout * - 1,590
    deductible itemized deductions 24,410 - 24,410
minus 4 personal exemptions (h/o 1A)       - 12,848
equals taxable income   192,742
minus NCG                   - 20,000
equals RTI $ 172,742

tax on RTI $37,772
    tax on $20,000 NCG @ 15%  3,000
    tax before credits 40,772
    minus child tax credit**  0
    $40,772
    minus withholding tax - 50,000
    Tax refund  $ 9,228

*Itemized deduction phaseout: $230,000 AGI - $150,500 = $79,500 x 2% = $1,590.

**The child tax credit is fully phased out at $230,000 of AGI.
Review Problem 3 Solution

Explanation of Transactions

(A) $152,000 is ordinary income.
(B) $2,000 is entered in the dividend column and will be included in NCG.
(C) Inheritances are excluded from income.
(D) This is a passive activity. The lesser of the $10,000 loss or $7,000 remaining at risk is entered in the passive column. She actively participates in the activity so it qualifies for the $25,000 real estate exception.
(E) $12,000 alimony is deductible as an adjustment.
(F) Medical expenses are deductible as an itemized deduction to the extent they exceed 7½% of AGI. $8,000 is entered in medical expense column.
(G) $5,000 qualified mortgage interest is deductible as a regular itemized deduction.
(H) $1,500 of dues is an employee business expense, deductible as a 2% MID.
(I) $2,000 investment expenses are deductible as 2% MIDs.
(J) $2,250 real estate tax is deductible as a regular itemized deduction.
(K) $6,000 insurance gain from the involuntary conversion is entered in the PCC. “LT” is written next to the gain because the property was held more than one year.

The worksheet, transaction explanations and an explanation of the worksheet and tax computation are on the next three pages.
Review Problem 3 Worksheet

Make sure to put parentheses around loss amounts; e.g., (1,000).

<table>
<thead>
<tr>
<th>Ordinary &amp; Portfolio</th>
<th>Dividends (NCG)</th>
<th>Passive</th>
<th>STCG(L)</th>
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<th>PCC</th>
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<th>Other Itemized</th>
<th>§ 221 &amp; 222 Adjustments</th>
<th>Adjustments</th>
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</thead>
<tbody>
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<td>A) 152,000</td>
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<td>E) 12,000</td>
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<td>160,000</td>
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<td>B) 2,000</td>
<td>D) (7,000)RE</td>
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<td>C) (7,000)</td>
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</tr>
</tbody>
</table>

- **K)** 6,000<sup>LT</sup> to LT 6,000
- **(PCC)** 6,000 to CGNI 6,000
### Tax Computation for Review Problem 3

#### Gross Income
- salary $152,000
- dividends 2,000
- CGNI 6,000
  - gross income 160,000

#### Adjustments
- alimony (12,000)
- MAGI for RE passive loss 148,000
- minus passive loss (1,000)
- AGI (no § 221 and §222 deductions) $147,000

#### Itemized Deductions

<table>
<thead>
<tr>
<th>Itemized Deductions</th>
<th>Itemized Deductions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2% MIDs</td>
<td></td>
</tr>
<tr>
<td>union dues</td>
<td>$1,500</td>
</tr>
<tr>
<td>investment expenses</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>3,500</td>
</tr>
<tr>
<td>-2% AGI</td>
<td>(2,940)</td>
</tr>
<tr>
<td>deductible 2% MIDs</td>
<td>560</td>
</tr>
<tr>
<td>Other Itemized</td>
<td></td>
</tr>
<tr>
<td>medical expenses</td>
<td>8,000</td>
</tr>
<tr>
<td>-7½ % AGI</td>
<td>(11,025)</td>
</tr>
<tr>
<td>deductible medical expenses</td>
<td>0</td>
</tr>
<tr>
<td>mortgage interest</td>
<td>5,000</td>
</tr>
<tr>
<td>real estate taxes</td>
<td>2,250</td>
</tr>
<tr>
<td></td>
<td>7,810</td>
</tr>
<tr>
<td>no phaseout (AGI less than $150,500)</td>
<td>0</td>
</tr>
<tr>
<td>equals deductible itemized deductions</td>
<td>7,810</td>
</tr>
<tr>
<td>minus exemption (no phaseout, AGI less than $150,500)</td>
<td>(3,300)</td>
</tr>
<tr>
<td>equals taxable income</td>
<td>$135,890</td>
</tr>
</tbody>
</table>

#### Tax Computation
- taxable income $135,890
- minus NCG (8,000)
- equals RTI 127,890
- tax on 127,890 RTI 30,141
- tax on 8,000 NCG @ 15% 1,200
- tax before credits $31,341
  - There are no credits.
Explanation of the Worksheet and Computation

This explanation follows the Steps handout.

Step 1. Each transaction was explained in the blue book and entered in the appropriate columns of the worksheet, identified with the letter of the transaction.

Step 2. After all transactions were entered in the worksheet, the PCC column was totaled. The column total is a $6,000 gain; the entire gain was from long-term property so the $6,000 gain was entered in the LTCG(L) column, identified as “PCC.”

Step 3. There were no short-term losses so the $6,000 LTCG (CGNI) was entered in the ordinary income column. The $2,000 dividend total was entered in the ordinary column. The rest of the columns were totaled.

The following steps were done on the computation page.

Step 4. Gross income items were added and regular adjustments were subtracted to arrive at $148,000 MAGI for the passive loss deduction.

Step 5. The passive column total was a $7,000 loss and it qualified for the real estate exception. $1,000 of the loss is deductible, calculated as follows: $150,000 - $148,000 MAGI = $2,000 ÷ 2 = $1,000 of RE exception remaining. $1,000 is the lesser of the RE loss, the column total and the exception remaining. The $1,000 passive loss was subtracted from $148,000 MAGI to arrive at $147,000 of MAGI for § 221.

Step 6. The taxpayer did not have any tuition expense or student loan interest so AGI is $147,000.

Step 7. 2% of AGI was subtracted from the 2% MID total and 7½% of AGI was subtracted from the medical total. Itemized deductions totaled $7,810 before phaseout.

Step 8. AGI did not exceed $150,500, so there is no itemized deduction phaseout. If AGI had exceeded $150,500, the phaseout would have been AGI - $150,500 x 2%.

Step 9. $7,810 of itemized deductions exceeded the $5,150 standard for a single taxpayer so $7,810 was subtracted from AGI.

Step 10. AGI did not exceed $150,500, so there is no exemption phaseout. If AGI had exceeded $150,500, h/o 1A would have been used to determine the exemption deduction. $3,300 was deducted from AGI to arrive at $135,890 of taxable income.

Step 11. $8,000 of NCG (and RE LTCG, if any) was subtracted from $135,890 of taxable income to get $127,890 RTI. The tax on RTI is 30,141; the tax on NCG at 15% is $1,200. The total tax is $31,341.

Step 12. No credits are available.
Solution to the Casebook Chapter 1 Problem Using 2006 Rates

Transactions

1. The $240,000 of cash, checks, and the value of the services they received are ordinary income.
2. They are on the cash basis and will not report this income until they receive it.
3. $45,000 of wages and $5,000 of supplies are ordinary business expenses of self-employed taxpayers, deductible as adjustments.
4. $5,000 of depreciation (per syllabus) is deductible as an adjustment.
5. Commuting expenses are personal and not deductible.
6. $9,000 of interest is ordinary income. The $500 investment management fee is deductible as a 2% MID under § 212 as an expense incurred for the production of income.
7. $10,000 of mortgage interest expenses is deductible as regular itemized deduction.
8. They have a $15,000 LTCG on the sale of the stock and $1,000 of dividends.
9. $5,000 of charitable contributions are deductible as a regular itemized deduction.
10. They can deduct the greater of the $500 sales tax or the $3,000 of state income tax they paid as a regular itemized deduction. The $2,000 of real property tax is deductible as a regular itemized deduction.
**TAX COMPUTATION WORKSHEET  Casebook Chapter 1 Problem**

*Make sure to put parentheses around loss amounts; e.g., (1,000).*

<table>
<thead>
<tr>
<th>Ordinary &amp; Portfolio (NCG)</th>
<th>Dividends (Passive)</th>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>PCC</th>
<th>Medical</th>
<th>2% MIDs</th>
<th>Other Itemized</th>
<th>§ 221 &amp; § 222 Adjustments</th>
<th>Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) 240,000</td>
<td>8) 1,000</td>
<td></td>
<td></td>
<td>8) 15,000</td>
<td></td>
<td></td>
<td>6) 500</td>
<td>7) 10,000</td>
<td>3) 45,000</td>
<td></td>
</tr>
<tr>
<td>6) 9,000</td>
<td>div 1,000</td>
<td>1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3) 5,000</td>
<td></td>
</tr>
<tr>
<td>CGNI 15,000</td>
<td>265,000</td>
<td></td>
<td>1,000</td>
<td></td>
<td></td>
<td></td>
<td>15,000</td>
<td></td>
<td>4) 5,000</td>
<td>55,000</td>
</tr>
</tbody>
</table>
Casebook Chapter 1 Problem Computation

<table>
<thead>
<tr>
<th>Gross Income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>consulting fees</td>
<td>$240,000</td>
</tr>
<tr>
<td>interest</td>
<td>9,000</td>
</tr>
<tr>
<td>dividends</td>
<td>1,000</td>
</tr>
<tr>
<td>CGNI</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>gross income</strong></td>
<td><strong>265,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adjustments</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>wages</td>
<td>$45,000</td>
</tr>
<tr>
<td>office supplies</td>
<td>5,000</td>
</tr>
<tr>
<td>depreciation</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>total adjustments</strong></td>
<td><strong>55,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>AGI</th>
<th>210,000</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Itemized Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2% MIDs</td>
<td></td>
</tr>
<tr>
<td>management fee</td>
<td>500</td>
</tr>
<tr>
<td>minus 2% x $210,000 AGI</td>
<td>-4,200</td>
</tr>
<tr>
<td>none deductible</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Itemized Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>mortgage interest</td>
<td>10,000</td>
</tr>
<tr>
<td>charitable contributions</td>
<td>5,000</td>
</tr>
<tr>
<td>real property taxes</td>
<td>2,000</td>
</tr>
<tr>
<td>state income tax</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>total itemized deductions</strong></td>
<td><strong>20,000</strong></td>
</tr>
<tr>
<td>§ 68 phaseout (210,000 - 150,500 = 59,500 x 2%)</td>
<td>-1,190</td>
</tr>
<tr>
<td>deductible itemized deductions</td>
<td>18,810</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Personal Exemptions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>($3,300 x 4) (no phaseout)</td>
<td>-13,200</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td>$177,990</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax Computation</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>taxable income</td>
<td>$177,990</td>
</tr>
<tr>
<td>less NCG</td>
<td>-16,000</td>
</tr>
<tr>
<td><strong>equals RTI</strong></td>
<td>$161,990</td>
</tr>
</tbody>
</table>

| tax on $161,990 RTI              | $34,761 * |
| tax on $16,000 NCG @ 15%         | +2,400 |
| **tax**                          | **$37,161** |

The child tax credit is phased out. They have two children under 17, so the CTC is $2,000 before phaseout. The CTC is phased out by $50 for each $1,000 (or fraction) that AGI exceeds $110,000 on a joint return ($75,000 on a single return). Their AGI is $210,000, which is 100 thousand over $110,000. $50 x 100 = $5,000 phaseout; the CTC is fully phased out.

*Computation of the tax using the tax rate schedule on h/o 1

$161,990 RTI falls in the bracket between $123,700 and $188,450 of taxable income.

The tax is $24,040 plus 28% of RTI over $123,700.

$161,990 RTI minus $123,700 equals $38,290. $38,290 x 28% = **$10,721**.

The tax is $34,761 ($24,040 + $10,721).
MILLIE REVIEW PROBLEM

Millie, a 31-year-old single physician, gives you the following 2006 income tax information and asks you to compute her 2006 income tax.

A. She received $136,000 in fees.

B. She paid $22,545 of home mortgage interest.

C. Her 2005 tax return shows a $4,000 STCL carryover.

D. She is making the following payments to her former husband pursuant to a written separation agreement: $300,000 in 2005, $10,000 in 2006 and $25,000 from 2007 to 2009. All payments end on her husband’s death.

E. She sold AA stock in June for $14,500 that she inherited from her aunt. Her aunt paid $9,000 for the stock in November 2005 and it was worth $12,000 on the date of her aunt’s death in March 2006.

F. She paid $12,000 to her psychiatrist for therapy.

G. She paid $122,000 for equipment (7-year property) for her practice in May 2005. This October a fire destroyed it and she received $100,000 of insurance. She paid $91,000 for replacement equipment (7-year property) in December. She elected to deduct $102,000 of first-year expensing.

H. She received U.S. Treasury bond interest of $1,898 and dividends of $3,500.

I. A thief stole a painting worth $50,000 in May that she bought for $5,000 in 2004. She received $43,000 of insurance in October and bought a similar painting for $40,000 in November.

J. A fire destroyed an oriental rug worth $18,000 in October 2006 that she bought for $16,100 in November 2005. She received $15,000 of insurance and purchased a replacement rug for $11,250 in December.

K. In March 2004, she paid $17,000 to invest in a real estate partnership in which she actively participates. She deducted a $2,000 loss in 2004. In 2005, the partnership broke even. In June 2006 she received a $500 cash distribution from the partnership. Her share of the partnership loss for 2006 is $16,000.

L. She paid her attorney $5,000 to represent her in an IRS audit.

M. Rich Uncle Henry gave her a $200,000 birthday gift in February.

N. She paid $100,000 for an interest in a real estate partnership in 2005, paying $30,000 in cash and borrowing $70,000 on a nonrecourse note. She does not participate in the activities of the partnership. She deducted $27,000 of loss from the partnership in 2005. Her share of the 2006 partnership income was $1,000.

O. She paid $5,000 for BB stock on 5/15/05 and sold it for $15,000 on 5/15/06.

P. She paid $25,000 for CC stock on 2/12/05 and sold it for $39,500 on 6/11/06.

Q. She paid $14,000 for tuition to attend law school at night.
**MILLIE SOLUTION**

**Entering Transactions**

A. $136,000 of ordinary income.

B. $22,545 of home mortgage interest is deductible as a regular itemized deduction.

C. The $4,000 STCL carryover is entered in the ST capital column.

D. $10,000 of alimony is deductible as an adjustment; recapture is not considered until the third post-separation year.

E. Millie’s basis is the $12,000 FMV on date of death so she had a $2,500 LTCG. Property inherited from a decedent is always long-term.

F. $12,000 is deductible as a medical expense.

G. This is an involuntary conversion.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of equipment</td>
<td>$122,000</td>
</tr>
<tr>
<td>- 2005 first-year expensing</td>
<td>-102,000 (amount she elected to deduct)</td>
</tr>
<tr>
<td>Basis remaining for depreciation</td>
<td>20,000</td>
</tr>
<tr>
<td>- 2005 regular depreciation</td>
<td>-2,860 ($20,000 remaining basis x 14.3%)</td>
</tr>
<tr>
<td>- 2006 depreciation</td>
<td>-2,450 ($20,000 x 24.5% x ½ year)</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$14,690</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
<td>$100,000</td>
</tr>
<tr>
<td>Minus adjusted basis</td>
<td>-14,690</td>
</tr>
<tr>
<td>Gain realized</td>
<td>$85,310</td>
</tr>
</tbody>
</table>

She deducted $107,310 of depreciation so the entire gain will be ordinary income when it is recognized.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance proceeds</td>
<td>$100,000</td>
</tr>
<tr>
<td>Minus cost of replacement property</td>
<td>-91,000</td>
</tr>
</tbody>
</table>
| Gain that must be recognized                     | 9,000      
| Ordinary income                                  |            |

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain realized</td>
<td>$85,310</td>
</tr>
<tr>
<td>Minus gain recognized</td>
<td>-9,000</td>
</tr>
<tr>
<td>Equals gain deferred</td>
<td>$76,310</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of replacement property</td>
<td>$91,000</td>
</tr>
<tr>
<td>Minus gain deferred</td>
<td>-76,310</td>
</tr>
<tr>
<td>Basis of replacement property</td>
<td>$14,690</td>
</tr>
</tbody>
</table>

The entire $14,690 basis of the replacement property is deductible under § 179 first-year expensing.

The following amounts are entered on the tax worksheet:

1. $2,450 in the adjustment column for depreciation on the old equipment;
2. $9,000 in the ordinary income column for the gain that must be recognized;
3. $14,690 in the adjustment column for depreciation on the new equipment.
H. $1,898 of interest on U.S. bonds is taxable as ordinary income. $3,500 of dividends are entered in the dividend column and will be taxed as net capital gain.

I. This is an involuntary conversion. She realized a $38,000 gain on the stolen painting ($43,000 insurance - $5,000 basis). $3,000 of the proceeds were not reinvested in replacement property so $3,000 of gain is entered in the PCC column, identified as long-term.

J. Millie has a $1,100 loss on the involuntary conversion of the rug ($16,100 minus $15,000 insurance recovery). $100 of the loss is not deductible; the $1,000 balance of the loss is entered in the PCC, identified as short-term.

K. Real estate investments are passive activities. She actively participated in the activity so it qualifies for the $25,000 real estate exception. The amount at risk is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>$17,000</td>
</tr>
<tr>
<td>2004 deduction</td>
<td>-2,000</td>
</tr>
<tr>
<td>Cash distribution</td>
<td>-500</td>
</tr>
<tr>
<td>Remaining at risk</td>
<td>$14,500</td>
</tr>
</tbody>
</table>

Only $14,500 of the $16,000 loss is deductible and is entered in the passive column identified with a RE to show it qualifies for the $25,000 RE exception. The $500 cash distribution is not income; it is a return of her investment and reduced her amount at risk.

L. The $5,000 fee is deductible under § 212 and is entered in the 2% MID column.

M. Gifts are excluded from income.

N. $1,000 of income from a nonqualifying passive real estate activity is entered in the passive column. The amount at risk is not relevant in a year the taxpayer has income from the activity.

O. She held the BB stock exactly one year; the $10,000 gain is entered in the ST capital column.

P. She held the CC stock more than one year; the $14,500 gain is entered in the LT capital column.

Q. Law school tuition is not deductible because it prepares her for a new trade or profession. It may qualify for the Lifetime Learning credit or the § 222 deduction depending on her AGI; this will be determined later.
MILLIE’S 2006 TAX COMPUTATION WORKSHEET

Make sure to put parentheses around loss amounts; e.g., (1,000).

<table>
<thead>
<tr>
<th>Ordinary &amp; Portfolio</th>
<th>Dividends (NCG)</th>
<th>Passive</th>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>PCC</th>
<th>Medical</th>
<th>2% MIDs</th>
<th>Other Itemized</th>
<th>§ 221 &amp; § 222 Adjustments</th>
<th>Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>A) 136,000</td>
<td>H) 3,500</td>
<td>K) (14,500)</td>
<td>C) (4,000)</td>
<td>E) 2,500</td>
<td>I) 3,000</td>
<td>F) 12,000</td>
<td>L) 5,000</td>
<td>B) 22,545</td>
<td></td>
<td>D) 10,000</td>
<td></td>
</tr>
<tr>
<td>G) 9,000</td>
<td>N) 1,000</td>
<td>O) 10,000</td>
<td>P) 14,500</td>
<td>J) 1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>G) 2,450</td>
<td></td>
</tr>
<tr>
<td>H) 1,898</td>
<td>Div 3,500</td>
<td>[(13,500)]</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>G) 14,690</td>
<td></td>
</tr>
<tr>
<td>CGNI 25,000</td>
<td>←</td>
<td>(PCC) 1,000</td>
<td>←</td>
<td>(PCC) 3,000</td>
<td>← to LT 3,000</td>
<td>← to (1,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>175,398</td>
<td>←</td>
<td>← to CGNI 5,000</td>
<td>← to CGNI 20,000</td>
<td>← to ST (1,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### MILLIE’S TAX COMPUTATION

**Gross Income**
- law practice: $136,000
- dividends: $3,500
- depreciation recapture: $9,000
- interest income: $1,898
- CGNI: $25,000
  - total gross income: $175,398

**minus Adjustments**
- alimony: $10,000
- depreciation: $2,450
- depreciation: $14,690
  - total adjustments: $27,140

**MAGI for passive loss**
- passive loss: $150,000 - $148,258 = $1,742 / 2 = $871
  - minus passive loss deduction: $-871

**§ 221 MAGI**
- $147,387

**She did not pay any § 221 student loan interest**
- § 222 MAGI > $80,000, so no tuition deduction

**AGI**

<table>
<thead>
<tr>
<th>Itemized Deductions</th>
<th>2% MIDs</th>
<th>Deductions</th>
</tr>
</thead>
<tbody>
<tr>
<td>attorney’s fee</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>minus 2% AGI</td>
<td>-2,948</td>
<td></td>
</tr>
<tr>
<td>deductible MIDs</td>
<td>2,052</td>
<td>2,052</td>
</tr>
</tbody>
</table>

**medical expenses**
- deductible medical expenses: $946
- mortgage interest: $22,545

**total and deductible itemized deductions**
- total: $25,543

**equals taxable income**
- $118,544

**Tax Calculation**
- taxable income: $118,544
- minus NCG (LTCG & dividends): $-23,500
  - equals RTI: $95,044

**tax on $95,044 RTI**
- $20,944

**tax on $23,500 NCG @ 15%**
- $3,525

**total tax before credits**
- $24,469

AGI exceeded $55,000; the Lifetime Learning credit is fully phased out.
Facts

Bruce and Carol Wilson had the following tax transactions in 2006. They are both 37-years-old and have a 10-year-old son. Determine their 2006 income tax.

(A) Bruce’s salary was $50,000 and Carol’s salary was $42,000.

(B) Sold Xerox stock on 5/7/06 for $36,900 purchased on 3/17/97 for $23,000.

(C) Carol’s uncle purchased Motorola stock in 1996 for $15,000. He gave it to her on 11/5/05 when it was worth $7,000 and she sold it 1/9/06 for $4,000.

(D) Paid $6,000 of real estate tax and $12,000 of mortgage interest.

(E) Paid $1,200 for investment expenses and $2,800 for unreimbursed employee expenses.

(F) They paid $250,000 in 2005 for a real estate investment in which they actively participate. They paid $30,000 of cash and borrowed $220,000 from the seller on a nonrecourse loan. On their 2005 return, they deducted $15,000 of loss. Their share of the 2006 loss is $40,000 and they received a $5,000 cash distribution in 2006.

(G) They paid $10,000 to a faith-healer to treat their son.

(H) A thief stole an antique vase worth $5,000 from their home on 2/7/06. They paid $3,000 for the vase in 1997 and received $4,500 of insurance proceeds on 6/2/06. They purchased a new vase for $3,900 on 11/4/06.

(I) They paid $200,000 for a rental condominium on 10/16/04 and sold it on 2/3/06 for $213,500. There were no income or expense items in 2006, but deduct the appropriate amount of depreciation for 2006. (Do not treat this as a passive activity for purposes of this problem.)

(J) Carol paid $5,000 of alimony to her former husband.

(K) They paid $7,000 to an after-school program to take care of their son while they worked.

(L) Carol attends college part-time to earn her bachelor’s degree and spent $6,500 for tuition and fees in 2006. She will be a senior in the fall. If they are eligible for a § 25A education credit and the § 222 deduction, they will elect the credit unless it is partially or fully phased out.

(M) They received $3,000 of dividends in 2006.

(N) Bruce paid $3,000 of interest on his student loan.
BLUE BOOK ENTRIES

(A) $92,000 ordinary income

(B) $36,900 - $23,000 = $13,900 LTCG

(C) Basis for purposes of a loss is the lower of the $7,000 FMV on date of gift or $15,000 donor’s basis. $4,000 A/R - $7,000 basis = $3,000 STCL. The holding period begins on date of the gift if the donee cannot use the donor’s basis.

(D) $6,000 real estate taxes and $12,000 mortgage interest are regular itemized deductions

(E) $1,200 investment expenses and $2,800 employee business expenses are 2% MIDs

(F) cash investment $30,000 not qualified nonrecourse financing)

- 2005 deduction - 15,000
- 2006 distribution - 5,000
remaining at risk $10,000

$10,000 of loss entered in the passive column
cash distribution is not income, but reduced the amount at risk

(G) $10,000 deductible medical expense; the provider does not have to be a licensed physician

(H) insurance proceeds $4,500

- basis - 3,000
equals realized gain $1,500

insurance proceeds $4,500
- cost of replacement property - 3,900
equals gain recognized $600 entered in PCC as long-term

(I) cost $200,000

2004 depreciation: (200,000 x .00758) 1,516
2005 depreciation: (200,000 x .03636) 7,272
2006 depreciation: ($7,272 ÷ 12 x 1.5) - 909

total depreciation 9,697 9,697
adjusted basis $190,303

amount realized $213,500
minus adjusted basis -190,303
equals realized gain $23,197

$909 current year’s depreciation is an adjustment
$9,697 of gain is RE LTCG (amount of depreciation deducted)
$13,500 balance of the gain is LTCG

(J) $5,000 alimony is an adjustment

(K) $3,000 (maximum for one child) of expenses qualify for the dependent care credit. The percentage depends on AGI and will be determined later.

(L) eligible for LLC (not Hope – beyond second year of college) or § 222 deduction. deduction or credit depends on AGI; will be determined later

(M) $3,000 is entered in the dividend column

(N) $2,500 maximum of student loan interest is an adjustment; deduction depends on § 221 MAGI to be determined later.
**WILSON TAX COMPUTATION WORKSHEET**

*Make sure to put parentheses around loss amounts; e.g., (1,000).*

<table>
<thead>
<tr>
<th>Ordinary &amp; Portfolio</th>
<th>Dividends (NCG)</th>
<th>Passive</th>
<th>STCG(L)</th>
<th>RE LTCG</th>
<th>LTCG(L)</th>
<th>PCC</th>
<th>Medical</th>
<th>2% MIDs</th>
<th>Other Itemized</th>
<th>§ 221 &amp; § 222 Adjustments</th>
<th>Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>A) 92,000</td>
<td>Div 3,000</td>
<td>M) 3,000</td>
<td>F) (10,000)</td>
<td>C) (3,000)</td>
<td>(3,000)</td>
<td>(3,000)</td>
<td>I) 9,697</td>
<td>B) 13,900</td>
<td>13,500</td>
<td>PCC 600</td>
<td>28,000</td>
</tr>
<tr>
<td>CGNI 34,697</td>
<td>129,697</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

*(or 2,000, subj to MAGI)*
WILSON TAX COMPUTATION

Gross Income
salary $92,000
dividends 3,000
CGNI 34,697
   gross income 129,697

Adjustments
alimony $5,000
depreciation 909
   total adjustments 5,909 (5,909)
MAGI for passive loss deduction 123,788
   minus passive loss deduction (see next page) (10,000)
MAGI for LLC and § 222 deduction 113,788 (MAGI for LLC, which is phased out)
   minus student loan interest deduction (see next page) (1,775)
§ 222MAGI 112,013
   minus tuition deduction (see next page) (4,000)
AGI $108,013

Itemized Deductions

2% MIDs
investment expenses $1,200
employee business expenses 2,800
   total 2% MIDs 4,000
   -2% AGI (2,160)
   equals deductible 2% MIDs 1,840 $1,840

Other Itemized
medical 10,000
   -7½ % AGI (8,101)
   deductible medical expense 1,899 1,899
real estate taxes 6,000
mortgage interest 12,000
   itemized deductions before phaseout 21,739
   AGI <$150,500; no phaseout 0
   deductible itemized deductions 21,739 (21,739)

minus exemptions (AGI <$225,750; no phaseout) (9,900)
taxable income $76,374

Tax Computation
taxable income $76,374
   minus NCG (28,000 LTCG + 3,000 div) (31,000)
   minus RE LTCG (6,697)
   equals RTI 38,677

   tax on 38,677 RTI $5,047
tax on 6,697 RE LTCG @ 15% 1,005
tax on 15,926 NCG @ 5% 796
tax on 15,074 NCG @ 15% 2,261
equals tax before credits 9,109

Credits
   dependent care credit (see next page) (600)
   child tax credit (see next page) (1,000)
equals tax $7,509
**Explanation of Computations**

**real estate passive loss deduction**

$150,000 ceiling - $123,788 MAGI for passive = $26,212 \div 2 = $13,106 exception remaining. 
Deduct $10,000 (the lesser of the loss, exception remaining or the column total)

**student loan interest deduction**

Phased out on joint return between MAGI $105,000 and $135,000 on joint returns 
$135,000 ceiling - $113,788 MAGI for student loan deduction = $21,212 
$21,212 \div $30,000 phaseout range = 71% deduction remaining (rounded) 
$2,500 maximum x 71% = $1,775 deduction

**tuition deduction**

LLC is totally phased out on a joint return at $110,000 of MAGI 
MAGI for § 222 tuition deduction is less than $130,000 so $4,000 is deductible

**dependent care credit:** $3,000 x 20% (percentage at their AG) = $600

**child tax credit:** $1,000; no phaseout because AGI is less than $110,000.
The table below illustrates the benefit of starting early to save for retirement. Barb invested $4,000 a year in her IRA account for the first eight years of a 40-year period, with annual compounding at 8¾%. Bob invested $4,000 a year at 8¾% from years 9 to 40. Bob’s total contribution is four times greater than Barb’s, yet he earned 17% less interest.

<table>
<thead>
<tr>
<th>Year</th>
<th>Barb’s Early Funding</th>
<th>Bob’s Late Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Contribution</td>
<td>Year-end Value</td>
</tr>
<tr>
<td>1</td>
<td>$4,000</td>
<td>$ 4,350</td>
</tr>
<tr>
<td>2</td>
<td>4,000</td>
<td>9,081</td>
</tr>
<tr>
<td>3</td>
<td>4,000</td>
<td>14,226</td>
</tr>
<tr>
<td>4</td>
<td>4,000</td>
<td>19,821</td>
</tr>
<tr>
<td>5</td>
<td>4,000</td>
<td>25,905</td>
</tr>
<tr>
<td>6</td>
<td>4,000</td>
<td>32,522</td>
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<tr>
<td>7</td>
<td>4,000</td>
<td>39,718</td>
</tr>
<tr>
<td>8</td>
<td>4,000</td>
<td>47,543</td>
</tr>
<tr>
<td>9</td>
<td></td>
<td>51,703</td>
</tr>
<tr>
<td>10</td>
<td>56,227</td>
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<td>11</td>
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<tr>
<td>18</td>
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<tr>
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<tr>
<td>21</td>
<td>141,470</td>
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<tr>
<td>22</td>
<td>153,849</td>
<td>4,000</td>
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<tr>
<td>23</td>
<td>167,311</td>
<td>4,000</td>
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<td>24</td>
<td>181,951</td>
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<td>25</td>
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<td>300,975</td>
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<tr>
<td>37</td>
<td>541,423</td>
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<tr>
<td>38</td>
<td>588,798</td>
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<tr>
<td>39</td>
<td>640,318</td>
<td>4,000</td>
</tr>
<tr>
<td>40</td>
<td><strong>Balance</strong></td>
<td><strong>$696,346</strong></td>
</tr>
</tbody>
</table>

Investment: $32,000  Investment: $128,000
Interest: $664,320  Interest: $550,430
1. INTRODUCTION

The table on the previous page illustrates the fact that the earlier you begin saving, the more you will have available at retirement. Employees should always try to take maximum advantage of retirement plans, especially if the employer provides matching funds. Contributions to deductible IRAs are adjustments; contributions to a 401(k) are excluded from income. A $1,000 contribution by a taxpayer in the 25% bracket costs only $750 after the $250 tax savings. Amounts contributed by the employer are excluded from the employee’s income.

This handout explains the basic provisions of the most common plans.

2. REGULAR IRAS

A. Contribution Limit and Phaseout of Deduction

In 2007, the maximum contribution is the lesser of earned income or $4,000. A “spousal” IRA can be set up for a non-working spouse based on the income of the working spouse. A taxpayer can make the maximum contribution regardless of AGI if neither the taxpayer or her spouse is a “plan participant” (participates in an employer retirement plan). If the taxpayer and/or the spouse is a plan participant, the deduction is phased out over the following AGI ranges:

- single return: $52,000-$62,000
- joint returns: participant spouse: $83,000-$103,000; nonparticipant: $156,000-$166,000

For example, assume a couple’s AGI is $110,000 and the wife participates in her employer’s 401(k) plan but the husband’s employer does not have a retirement plan. The deduction for the wife’s contribution is fully phased out, but her husband may deduct his IRA contribution.

B. Deductible IRAs

The tax on earnings is deferred until withdrawn. Amounts withdrawn are taxed as ordinary income, even if most of the appreciation is attributable to long-term capital gains. Participants must start withdrawing funds from their IRA at age 70½.

There is a 10% penalty on withdrawals before age 59½ (in addition to the tax on the amount withdrawn). There is no penalty if the withdrawal is made for (1) medical expenses greater than 7½% of AGI or complete disability, (2) education expenses for self, spouse, children and grandchildren, or (3) purchasing a first home, with a limit of $10,000.

C. Nondeductible IRAs

If the deduction is phased out, the taxpayer may still contribute to a nondeductible IRA. The $4,000 contribution limit is the same as for deductible contributions, but there is no AGI limit. The earnings are tax-deferred accumulation until withdrawn. When funds are withdrawn, they are taxed like an annuity; the nondeductible contributions are the “investment in the contract” and an exclusion ratio is computed based on the taxpayer’s life expectancy. Nondeductible IRAs are similar to investments in annuities, but contributions to annuities have no dollar limits. IRA investments are totally self-directed, while investments in annuity contracts are less flexible.
3. **ROTH IRAs**

ROTH IRAs are one of the best gifts Congress ever gave taxpayers. Contributions are not deductible and the income is tax-deferred until withdrawn. Withdrawals are tax-free if the amount withdrawn has been held at least five years and the withdrawal occurs after age 59½. An employee may withdraw up to $10,000 tax-free before age 59½ if the funds are used to purchase a first home.

The maximum contribution is the lesser of earned income or $4,000. Contributions can be made to a Roth for a non-working spouse based on the earned income of the working spouse. There is no age limit; minors can contribute to Roth IRAs if they have earned income. The contribution is reduced by amounts contributed to a regular IRA, but not by contributions to a 401(k) plan. The maximum is phased out for single taxpayers from AGI of $99,000 - $114,000 and for married taxpayers from AGI $156,000 - $166,000.

4. **DEFINED BENEFIT PLANS**

In a defined benefit plan, the employer promises to pay a defined amount to retirees who meet certain eligibility criteria. In other words, the plan defines the retirement benefit. The plan typically pays a lifetime monthly benefit to retirees linked to the length of service and final average salary. Employees can rely on a known and expected benefit level. For example, Chicago Public School teachers receive 2.2% of their final salary for each year of service, up to a maximum of 75%. (The actual formula is more complicated.) A teacher earning $75,000 who retires after 30 years will receive a pension of $49,500 per year (30 years x 2.2% = 66% x $75,000). The annual payment is increased 3% per year for inflation.

Defined benefit plans were the dominant form of employer-sponsored retirement programs until a few years ago. As life expectancies lengthened and corporations were looking for ways to reduce expenses, many large employers converted their defined benefit plans to defined contribution plans. Government employees and public school teachers typically benefit from these retirement plans.

5. **DEFINED CONTRIBUTION PLANS**

**401(k) and 403(b) Plans**

These plans define the maximum contributions that employers and employees can make to the plan, not the retirement benefit. 403(b) plans are offered by not-for-profit employers. At retirement, the employee receives the balance of the account in a current or deferred lump sum or annuity. Retirement income depends on the amount in the account and the employee’s life expectancy. There is no guarantee that the account will provide sufficient retirement income until the retiree’s death.

The employer typically makes contributions to the employee’s plan based on a percentage of the employee’s salary. The employer’s contribution is excluded from the employee’s income. The employee can also make contributions to the plan, which they exclude from income. The employer often “matches” a specified percentage of the employee’s contribution. The income in the account accumulates tax-deferred and withdrawals are taxed at ordinary income tax rates. The maximum that an employee can contribute is $15,500 in 2007. Employees over age 49 can contribute an additional $5,000 per year. The maximum contribution is not limited by the employee’s AGI.

For example, IIT contributes 5% of each employee’s salary to their 403(b) retirement account. If an employee elects to make voluntary contributions, IIT will make matching contributions up to 4% of the employee’s salary. Prof. Zorn earns $100,000 per year, so IIT contributes $5,000 to her 403(b) account. If she voluntarily contributes $4,000 (4% of her salary), IIT will contribute another $4,000.
Her $4,000 contribution and IIT’s $9,000 contribution are excluded from her income. If she is in the 28% tax bracket, her $4,000 contribution saves $1,120 of tax, making the after-tax cost of the contribution only $2,880. The result is that an additional $8,000 is contributed to her account ($4,000 from IIT and from her) at an after-tax cost of $2,880. As previously mentioned, it is extremely beneficial for an employee to contribute enough to maximize the employer’s matching contribution.

6. THE ROTH 401(k) AND ROTH 403(b)

These plans, which are a combination of the Roth IRA and a 401(k) plan, were first introduced in 2006. Employees can elect to make nondeductible contributions to a Roth 401(k) instead of excludible contributions to the conventional 401(k). In return, withdrawals from the plan will be tax-free, as with a Roth IRA, instead of taxed at ordinary rates, as with a 401(k). (The employer’s contribution must go to the regular 401(k) account.)

These plans can result in significant tax-free income at retirement available to employees. The maximum contribution to a Roth IRA is $4,000, but the maximum contribution to a Roth 401(k) is the same as to a regular 401(k) ($15,500 in 2007). In addition, if married taxpayers’ AGI exceeds $166,000 in 2007, they cannot contribute to a Roth IRA. However, there is no AGI limit for contributions to Roth 401(k) plans.

7. CREDIT FOR QUALIFIED RETIREMENT SAVINGS CONTRIBUTIONS

Code § 25B (not in your Selected Statutes) provides a tax credit to encourage lower-income workers to set money aside for retirement. The maximum contribution eligible for the credit is $2,000 per spouse for contributions to IRAs, 401(k)s, 403(b)s, and other employer-sponsored retirement plans. The credit is available to an individual over 17, but not to full-time students or individuals claimed as a dependent on another’s return. The credit is as follows for 2007:

<table>
<thead>
<tr>
<th>AGI on Joint Return</th>
<th>AGI on Single Returns</th>
<th>Credit Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $31,000</td>
<td>$0 - $15,500</td>
<td>50%</td>
</tr>
<tr>
<td>$31,001 - $34,000</td>
<td>$15,501 - $17,000</td>
<td>20%</td>
</tr>
<tr>
<td>$34,001 - $52,000</td>
<td>$17,001 - $26,000</td>
<td>10%</td>
</tr>
<tr>
<td>over $52,000</td>
<td>over $26,000</td>
<td>zero</td>
</tr>
</tbody>
</table>

For example, a married couple with AGI of $31,000 is entitled to a $1,500 tax credit if they each contribute $1,500 to their IRAs. This couple’s taxable income is $13,500 after subtracting $6,800 of exemptions and the $10,700 standard deduction; their tax is $1,350. The $1,500 credit eliminates the tax. However the credit is nonrefundable and the balance of the credit evaporates.