2008 Federal Tax Forms

2008 Income Tax Forms & Examples

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I. FACTUAL BACKGROUND

Walter and his wife Stacey are both 32. Walter is a self-employed computer consultant. Walter runs this business out of the home. Stacey is an elementary school teacher for the Iowa City School District. Stacey also began a candle manufacturing business in 2005. The couple had their first child, George, in September of 1998. They also adopted Grace, age 9, in 1999. Based on an interview with them and after reviewing their records, the following information was obtained:

A. FAMILY FACTS:

Walter and Stacey file a joint tax return.

Walter's social security number is 483-73-5777. Stacey's is 169-38-5543.

B. FAMILY INCOME:

1. Stacey's W-2 for 2008 showed $32,125 of wages, $3,115 of federal withholding, $1,434 of Iowa withholding and $4,000 of dependent care benefits. **(FORM 1040, LINES 7 and 64) (SCHEDULE A, LINE 5) (FORM 2441)**

2. Walter and Stacey received the following interest reported on Forms 1099 INT in 2008: **(SCHEDULE B, PART I)**

Iowa City Municipal Bond	310
Wells Fargo Bank	91
SmithBarney	1,205
TOTAL	1,606

3. Walter and Stacey received the following qualified dividends reported on Form 1099 DIV in 2008: **(SCHEDULE B, PART II)**

Pioneer Growth Fund	805
Money.www, Inc.	60
ABS Enterprises	40
ABBD, Inc.	210
TOTAL	1,115

Also, an additional $45 received from Pioneer Growth Fund were from long term capital gains distributions. **(SCHEDULE D, LINE 13)**

4. Walter's records show he sold the following stock in 2008: **(SCHEDULE D, PARTS I and II)**

Stock	Date Acquired	Date Sold	Selling Price	Purchase Price	Sales Comm.
Money.www, Inc.	01/09/99	04/10/08	5,260	3,400	10
Sell.com, Inc.	01/09/99	04/10/08	4,025	5,650	10
Tiny Equip. Co.	04/10/05	07/15/08	1,050	1,090	10
Big, Inc.	04/10/05	12/29/08	3,200	780	10

5. Walter and Stacey did a little gambling in 2008. Stacey won a total of $6,000, from which she received a W-2G. Stacey had records of gambling losses of $2,500 and Walter had records of gambling losses of $3,000 for 2007. **(FORM 1040, LINE 21) (SCHEDULE A, LINE 27)**

C. OTHER INVESTMENTS:

1. Walter owns an interest in PTP, Limited, a publicly traded limited partnership. Walter received a 2008 Schedule K-1 from this limited partnership with rental loss of $440 and interest income of $75. **(SCHEDULE E, PAGE 2) (SCHEDULE B, PART I) (FORM 8271) (FORM 8582)**

2. In 2008 Walter continued to lease the 4-plex that he acquired via like-kind exchange in 2004. The rental income amounted to $21,800, the rental expenses included: $250 for advertising, $975 for insurance, $12,262 mortgage interest, $6,155 for real estate taxes and $7,800 for repairs including a new roof that cost $5,950. Walter also had the depreciation of this 4-plex. Neither Walter nor any other family members have used this duplex for personal purposes in 2008. **(SCHEDULE E) (FORM 8582) (FORM 4562)**

3. Walter received a Schedule K-1 from NewCo, LLC for 2008. The Schedule K-1 from NewCo, LLC shows a rental loss of $470 and qualified dividends of $65. **(SCHEDULE E PAGE 2) (FORM 8582) (SCHEDULE B, PART II)**

D. WALTER'S FACTS:

1. In 2008, Walter's consulting business had gross sales of $108,197; office expense of $4,790, supply expense of $1,280, advertising expense of $1,438, telephone expense of $1,990, and insurance expense of $985.

   Walter continues to depreciate the office furniture that he purchased in 2004 for $6,000 and the computer purchased on July 1, 2005 for $3,800.

Walter used his fully depreciated Toyota 60% for his business and 40% for personal in 2008. Walter also used his 2004 Ford Excursion 100% for business. He had a total business fuel, insurance and maintenance costs of $4,520. He also paid license fees of $98 on the Toyota and $404 on the Ford. (See Schedule A, Line 7 regarding license fee).

Walter paid federal estimated tax payments of $20,000 and Iowa estimated tax payments of $3,500 in 2008.

(SCHEDULE C; FORM 4562; FORM 4797; FORM 8829; FORM 1040 , LINE 65; SCHEDULE A, LINE 5)

2. Walter took a distribution of $10,000 from his 401(k) in 2008 and invested it into his business. The 1099-R shows all $10,000 is taxable, with $2,000 of federal income tax withholding and $600 of Iowa withholding. **(FORM 1040, LINES 16, 60 AND 64; SCHEDULE A, LINE 5)**

E. STACEY'S FACTS:

1. In 2008, Stacey spent the following amounts on items for school for which she was not reimbursed by her employer: **(FORM 1040, LINE 23 AND FORM 2106-EZ)**

Instruction Materials	410
Supplies	180
Student Project Supplies	670
Prizes for Students	190
TOTAL	1,450

2. Stacey drove her personal car 971 miles for her employer in 2008. Stacey was not reimbursed for these miles. **(FORM 2106-EZ)**

3. Stacey continued her business of candle making in 2008. She manufactures the candles and sells them to local retail shops. Stacey had gross sales of $10,560 and the following expenses: supplies $4,806; advertising $191; rent $900; wages $1,050; sales tax $528; and employment tax $80.

   Stacey purchased $870 of new equipment on May 15, 2008.

   Stacey also traveled to Newport, Kentucky for a trade show in November, 2007. She drove 1,120 miles and stayed four days and four nights while at the trade show. She had $320 of hotel expense. **(SCHEDULE C; FORM 4562; FORM 8903)**

F. OTHER INFORMATION:

1. Refunds: Walter and Stacey received a refund of $1,070 in 2008 from the State of Iowa and had itemized their 2007 deductions. **(FORM 1040, LINE 10)**

2. Investment:

   a. Walter contributed $5,000 into a traditional IRA, while Stacey contributed $5,000 into a Roth IRA in 2008. **(FORM 1040, LINE 32) (FORM 8606 COMMENTARY)**

   b. The couple had an account at SmithBarney where they incurred $1,220 of investment interest expense on their margin account in 2008. **(SCHEDULE A, LINE 14 AND FORM 4952)**

3. Personal:

   a. The couple rent a safe deposit box for $35. **(SCHEDULE A, LINE 23)**

   b. Walter has a high deductible health insurance plan for the family, and has a Health Savings Account. Their family deductible is $3,500 per year, and he paid $2,689 in premiums. The family incurred $1,854 of medical expenses in 2007. Walter contributed $2,100 into the Health Savings Account and also received $1,854 in distributions from the account in 2008. **(FORM 1040, LINES 25 AND 29) (FORM 8889)**

   c. Walter paid $365 and Stacey paid $330 for qualified long term care insurance in 2008. **(FORM 1040, LINE 29)**

   d. Walter and Stacey made a number of charitable contributions in 2008. The cash gifts were as follows: **(SCHEDULE A, LINE 19)**

American Red Cross	1,000
American Cancer Society	500
St. Patrick Catholic Church	5,200
TOTAL	6,700

   They also gave 50 shares of BigCo, Inc. stock to the American Red Cross. The stock's fair market value was $1,508 and their basis was $460. Walter had owned this stock since March of 2001. **(FORM 8283)**

   e. Walter and Stacey incurred interest expense in 2008, which includes:

      (1) Home mortgage interest for their Iowa City residence totaling $8,210. **(FORM 8829, LINE 10 AND SCHEDULE A, LINE 10)**

(2) Walter continued to pay back his student loans in 2008. The total interest paid on these loans in 2008 was $710. **(FORM 1040 LINE 33)**

(3) Stacey continued to pay on her student loans in 2008. She paid $1,628 of interest on her loans in 2008. **(FORM 1040 LINE 33)**

f. The couple paid us $470 for tax preparation in 2008. **(SCHEDULE A, LINE 22 AND SCHEDULE C, LINE 17)**

g. In 2008, Walter and Stacey paid real estate taxes on their Iowa City home of $4,585. **(FORM 8829, LINE 11 AND SCHEDULE A, LINE 6)**

h. In 2008, the couple paid $81 for the license of Stacey's car, and $502 for Walter's car and truck. **(SCHEDULE A, LINE 7 AND SCHEDULE C)**

i. The couple has a full time nanny, Esther, in their home to care for their children. Esther was paid $160 per week and worked 24 weeks in 2008. **(SCHEDULE H; FORM 1040, LINE 62; AND FORM 2441)**

j. On occasion, when their in-house provider was unable to care for their children, they took the kids to Gramma's Care, a nearby day care center. They paid a total of $1,370 to Gramma's Care in 2008. **(FORM 2441)**

k. Walter and Stacey contributed $2,500 to the College Savings Iowa Program for both of their two children. **(SEE DISCUSSION AT THE END OF THIS OUTLINE)**

l. Stacey has continued to take classes towards receiving her Masters degree in teaching. In 2008 she paid a total of $645 in tuition for these classes. **(FORM 1040, LINE 34)**

II. FORM 1040 (Page One) AND COMMENTARY

A. <u>EXEMPTIONS (Line 6)</u>

For each dependent claimed on a tax return, the taxpayers are required to provide the correct social security number. A taxpayer who fails to include in his tax return the identification number (SSN or TIN) of any dependent may be disallowed to claim that dependent. See Form 1040 Instructions, line 6(c).

B. INCOME

Line 7 Wages, Salaries, Tips, etc.

a. **Tip Income**. The IRS issued Rev. Rul. 95-7 which addresses the issue of FICA taxes on tips. "Wages" for FICA includes all remuneration except those paid in non-cash form and those that are under $20 a month. Section §3121(q) requires the employer to pay FICA on the total amount of cash tips received by an employee up to and including contributions and benefit base under § 3121(a). If an employee fails to report tips to the employer, the employer is responsible for only the employer portion of the FICA taxes, and the employee is liable only for the employee portion of the FICA taxes on tips. Additionally, the 11th Circuit ruled that the IRS may assess the employer's share of FICA taxes on an employee's tip income without determining the employee's individual share in Morrison Restaurants, Inc. v. U.S., 118 F.3d 1526 (11th Cir. 1997). However, the 9th Circuit recently held that an aggregate assessment based on inaccurate estimates forces the employer to pay the price for its employee's dereliction. Fior D'Italia, Inc. v. U.S., 242 F.3d 844 (9th Cir. 2001).

Employees in the food and beverage industry can enter into either The Tip Rate Determination Agreement, which requires a determination of tip rates or a Tip Reporting Alternative Commitment which educates employees on reporting tips. These voluntary programs ensure the employer will not undergo a tip audit. Additionally, the IRS now allows for the employer to set up their own version of the educational program, but the IRS may revoke its acceptance at any time. See Notice 2001-1. This program was scheduled to expire in 2005, but has recently been extended indefinitely. (See IR 2004-117).

b. **Qualified Transportation Fringes**. The Energy Policy Act of 1992 created new Code § 132(f), governing the treatment of "qualified transportation fringes." These involve employer payment of certain commuting costs of employees. Subsequently, the IRS issued Notice 94-3 clarifying the rule. Rev. Proc. 2007-66 increases the limit on transportation fringe benefits to $115 per month and increases the qualified parking to $220 per month. Under this rule, an employer may provide the following fringe benefits tax-free to an employee:

(1) Vanpool or mass transit transportation to the job. The maximum tax-free amount is limited to $115 per month. Amounts in excess of this limit are taxable. For mass transit, the benefit must be provided in kind, in the form of a transit pass rather than in cash, except where transit passes may not be readily obtained by the employer for distribution.

(2) Free parking at or near the job site. This exclusion does not apply where an employer pays for an employee's cost of parking at or near his residence. The tax-free amount is limited to $220 per month. To be

nontaxable, these benefits must be offered as additional compensation to the employee. They may not be offered in lieu of cash compensation. Thus, they may not be offered tax-free as part of a cafeteria plan under Code section 125.

c. **Examples of Benefits Includable in Gross Income:**

(1) The value of the health insurance coverage provided to a non-spouse domestic partner, not a dependent of the employee, must be included as wages, subject to FICA, FUTA and income tax withholding. PLR 200108010 and PLR 200339001.

(2) Scholarships given to children of employees for undergraduate expenses where the scholarship program fails to meet the “pattern of employment” criteria of Rev. Proc. 76-47, must be included as wages subject to FICA, FUTA and income tax withholding. PLR 200049007

(3) Allowance paid for uniform cleaning and maintenance does not qualify as a working condition fringe benefit under § 132(d) where the employees are not required to verify to the employer that the allowance was actually used for such purposes. In such case, the allowance must be included as income. PLR 9443025 (July 27, 1994).

(4) Tool rental payments made by an employer to an employee for the use of the employees’ tools will generally be considered wages and subject to employment taxes. PLR 200006005

<u>Line 8</u>

a. <u>Taxable Interest</u>. - All taxable interest income must be reported on Part I of Schedule B, if:

(1) The taxpayer has over $1,500 in taxable interest, or

(2) Any "special rules" apply, such as when the taxpayer:

(a) receives seller financed mortgage interest;
(b) receives a 1099-INT as a nominee;
(c) pays accrued interest on bonds;
(d) receives tax-exempt interest;
(e) reports OID interest different than the amount stated on Form 1099-OID;
(f) reduces interest income on a bond by the amount of amortizable bond premium.

(3) The taxpayer is excluding interest from Series EE or I Bonds issued after 1989,

(4) The taxpayer had over $1,500 of ordinary dividends,

(5) The taxpayer received ordinary dividends as a nominee, or

(6) The taxpayer has a foreign account, or received a distribution from or was a grantor of, transferor to, a foreign trust.

Interest income from sales of real estate that are seller financed may require additional reporting. Real estate sold on a land contract or other form of seller financing results in reportable interest income to the seller. Additionally, if the real estate is used as the principal residence of the buyer, the seller is required to show the buyer's name, address and social security number on Schedule B. The seller must also inform the buyer of his/her social security number. Failure to follow these requirements may result in a $50 penalty for the seller.

Imputed Interest IRC §7872: If a lender does not charge interest at least equal to the AFR, the lender is considered to have imputed interest and is taxed on the difference between the AFR and the rate actually charged. The imputed interest is treated as a gift to the borrower. There are two exceptions to the imputed interest rules:

1. There will be no imputed interest if the aggregate outstanding balance of the loan(s) does not exceed $10,000 on any given day. However, this exception does not apply if the loan proceeds were used to acquire investment property.

2. For loans between $10,000 and $100,000, the imputed interest is limited to the borrower’s net investment income. If the borrower’s net investment income is less than $1,000, there will be no imputed interest. To qualify for this exception, the lender must have an annual statement that discloses the borrower's net investment income.

b. Tax-exempt Interest Taxpayers must show on their tax returns (Form 1040, Line 8b) the amount of tax-exempt interest they received or accrued during the tax year if they are required to file an income tax return. § 6012(d).

On the example tax return, the Burns have both taxable interest and also $310 of tax-exempt interest from the Iowa City Municipal Bond. (See Schedule B, Part I).

Line 9

a. Ordinary Dividends - Report all ordinary dividend income. Be sure to report the proper payer information on Line 5 of Schedule B. Also, remember the capital gain distributions reported on Form 1099-DIV go directly to Schedule D, line 13.

b. Qualified Dividends –Qualified Dividend Income ("QDI") is taxed at the same rates as the revised capital gain rates (0% for taxpayers in the 10% or 15% brackets and 15% for all other taxpayers). These rates remain in place through December 31, 2010, then in 2011 the rates revert back to pre-JGTRRA rates. If the taxpayer has qualified dividends, either Schedule D or the Qualified Dividends and Capital Gain Tax Worksheet are used to figure the tax.

Qualified dividend income does not include the following:

(a) Any dividend on any share of stock with respect to which the holding period requirements of §246(c) are not met. However, those holding period requirements are determined by substituting "61 days" for "45 days," and "121-day period" for 90-day period." In other words, if a shareholder does not hold a share of stock for more than 61 days during the 121-day period beginning 60 days before the ex-dividend date (in the case of certain preferred stock, 91 days during the 181-day period beginning 90 days before the ex-dividend date), dividends received on the stock are not qualified dividend income. (As amended by the Tax Technical Corrections Act of 2003. See IR 2004-22).

(b) Any dividend on any share of stock to the extent that the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property.

(c) Payments in lieu of dividends.

(d) Any amount which the taxpayer takes into account as investment income under §163(d)(4)(B).

(e) Any dividend from a corporation which for the tax year of the corporation in which the distribution is made, or the preceding tax year, is a corporation exempt from tax under §501.

(f) Any amount allowed as a deduction under §591 (deduction for dividends paid by mutual savings banks, etc.)

(g) any dividend described in §404(k) (deductible "applicable dividends" paid on "applicable employer securities" held by an ESOP).

The Burns have $1,180 ($1,115 + $65) of qualified dividend income.

The capital gain distributions from the Pioneer Growth Fund of $45 are reported directly to Schedule D, line 13. (See Schedule B, Part II and Schedule D, Line 13).

Line 10 Taxable Refunds, Credits, Etc. - Refunds from state and local income taxes are reportable as income when the taxpayer has taken that original state or local income tax liability as a deduction on their itemized deductions on previous years.

The attached state and local income tax refund worksheet shows that the Burns must report all of their $1,070 Iowa refund from 2006 that they received in 2007.

Line 11 — Alimony Received - Alimony received includes alimony and separate maintenance payments. The recipient of such payments must provide the payer with their social security number.

Line 12 — Business Income or (loss)

Which Schedule? Beginning in 1992, certain sole proprietorships may report their income on Schedule C-EZ, a simplified version of Schedule C. The requirements are as follows:

-Business expenses of $5,000 or less.
-Use the cash method of accounting.
-Did not have any inventory at any time during the year.
-Did not have a net loss from the business.
-Had only one business as a sole proprietor.
-Had no employees during the year.
-Are not required to file Form 4562 (depreciation and amortization).
-Do not deduct expenses for business use of your home.
-Do not have prior year unallowed passive activity losses from this business.

Walter Burns has a consulting business, therefore he must complete the following:

(1) Schedule C (Profit or Loss from Business) Walter cannot use Schedule C-EZ because Walter has over $5,000 in business expenses and needs to file Form 4562.

(2) Form 4562 (Depreciation & Amortization) for the depreciation of the computer, office equipment and the 2004 Ford.

Stacey *Burns has a candle manufacturing business she operates, therefore she must complete the following:*

(1) Schedule C (Profit or Loss from Business) Stacey cannot use Schedule C-EZ because Stacey has over $5,000 in business expenses, needs to file Form 4562 and has an employee.

(2) Form 4562 (Depreciation & Amortization) for the depreciation of equipment.

Line 13 a. Capital Gain or (loss)

After December 31, 2007, the top tax rate for long-term capital gains is 15% for taxpayers above the 15% bracket and 0% for those in the lower brackets.

These rates continue through 2010 and then revert back to pre-JGTRRA (10% and 20%) rates in 2011. However, for those taxpayers in the 10% or 15% brackets, the 2008 capital gains rate is 0%.

The reduced capital gain rates apply for purposes of the regular tax and the Alternative Minimum Tax.

Long-term capital gain from the sale of collectibles continues to be taxed at a maximum rate of 28%.

All depreciation from §1250 property (depreciable residential or non-residential income producing or business real property) will be recaptured. The straight-line depreciation recapture is taxed at 25%, while any additional depreciation recapture from the use of an accelerated method is ordinary income.

In September 2005, the President signed the Katrina Emergency Tax Relief Act of 2005 ("KETRA-2005"). This Act aids the victims of Hurricane Katrina as well as providing tax incentives to those helping the victims.

The replacement period for postponing gain on property located in the Hurricane Katrina disaster area that was converted after August 24, 2005, as a result of Hurricane Katrina, is extended to 5 years after the end of the first tax year in which any part of the gain on the conversion is realized, but only if substantially all of the use of the replacement property is in that disaster area. KETRA-2005.

Sale of Principal Residence. Up to $250,000 of home-sale profit is tax-free. The exclusion is doubled to $500,000 for married persons filing jointly. This provision has replaced the home-sale rollover rules and the up to $125,000 exclusion rules for home sellers age 55 and over. To qualify, the taxpayer must have lived in the house as her primary residence for at least two of the last five years unless the house was sold due to a change in place of employment (of at least 50 miles), the taxpayer's health, or other unforeseen circumstances. If one of these exceptions applies, the taxpayer receives a reduced maximum exclusion. The reduced maximum exclusion is calculated by the sum of the lesser of (1) the number of days the house was used as a main home or (2) the number of days the taxpayer owned the home divided by 730 days. The result is multiplied by the maximum exclusion of $250,000 ($500,000 for a joint return).

In PLR 200504012, the IRS determined that the taxpayer met the unforeseen circumstances test that allowed the taxpayer to exclude a portion of the gain on the sale of the taxpayer's house, even though the taxpayer had not lived in the house for the otherwise required two year period. The taxpayer's unforeseen circumstances, that required him to move and sell the house, was that the taxpayer had been selected to be a K-9 police officer and with that job came the requirement that he keep the dog and maintain a 6 x 9 foot kennel, which he was not able to do at his current residence.

Under the American Jobs Creation Act of 2004 ("AJCA-2004"), property acquired in a like-kind exchange is not allowed §121 treatment, if sold within five (5) years of the acquisition of the property. This is effective for sales or exchanges after October 22, 2004.

The Military Family Tax Relief Act of 2003 ("MFTRA-2003") creates a special exception to the two-out-of-five year rule for uniformed and foreign service personnel called to active duty away from home. They may elect to suspend the five-year test period. The maximum length of the suspension is 10 years and it may only be made with respect to one property. If the election is made, the five-year period ending on the date of the sale of a principal residence does not include any period up to 10 years during which the serviceman or woman, or his or her spouse, is on qualified official extended duty. MFTRA-2003 defines "qualified official extended duty" as any extended duty while serving at a duty station that is at least 50 miles from the taxpayer's principal residence or while residing in government quarters under government orders. "Extended duty" is any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite time. It is effective for sales made after May 6, 1997.

b. A taxpayer does not need to complete a Schedule D if:

1. The only amounts the taxpayer has to report on Schedule D are capital gain distributions from box 2a of Forms 1099-DIV or substitute statements and capital gain distributions from box 2b;

2. None of the Forms 1099-DIV have an amount in box 2c (qualified 5-year gain), box 2d (unrecaptured section 1250 gain), box 2e (section 1202 gain) or box 2f (collectibles (28%) gain); and

3. The taxpayer is filing Form 4952 (relating to investment interest expense deduction), the amount on line 4g includes any qualified dividends. It also includes all of the capital gain from the disposition of property held for investment.

If all three of the above conditions are met, these amounts are to be reported directly on line 13 of Form 1040, and the box to the left of that line needs to be checked. However, the taxpayer would still utilize the capital gain tax worksheet to compute the tax.

Page 2 of the Schedule D is no longer used to calculate tax if the taxpayer has income relating to §1250 gains and 28% gain on collectibles. Rather, the calculations are now in the instructions to Schedule D, and those affected taxpayers must turn to the worksheet in the instructions rather than Schedule D itself to calculate their tax. (See below).

On the example tax return, the Burns have capital gain and capital loss transactions, the capital gain distribution reported on a Form 1099-DIV as well as qualified dividend income (see discussion to line 9b). Therefore, their tax return must include Schedule D (Capital Gains & Losses) and the use of the Qualified Dividends and Capital Gains Tax Worksheet found in the Form 1040, Line 44 Instructions.

<u>Line 14</u> <u>Other Gains or (Losses)</u> - Generally these include the sale or exchange of assets used in the taxpayer's trade or business.

<u>Line 15</u> <u>IRA Distributions</u> - Distributions from an IRA are reported to the taxpayer on a 1099-R. The entire amount of the distribution is taxable, unless (1) the taxpayer had made nondeductible IRA contributions, or (2) the distribution was rolled over into another IRA. (The term IRA includes IRAs, SEPs and SIMPLE IRAs). If the taxpayer converts part or all of a traditional IRA to a Roth IRA, the taxpayer must fill out Form 8606 to calculate the proper amount reportable on line 15(b).

<u>Line 16</u> <u>Pensions and Annuities</u> - Distributions from Pensions or Annuities are also reported to the taxpayer on a 1099-R. These distributions are fully taxable if (1) the taxpayer did not contribute to the cost of the pension or annuity, or (2) the taxpayer has already received all of the cost in prior distributions. If the pension or annuity is only partially taxable, the taxpayer will generally have to use the General Rule to compute the taxable portion. However, depending on the starting date of the annuity, the taxpayer may be able to use the Simplified Method. Alternatively, the taxpayer can ask the IRS to figure the taxable portion for a $95 user fee. (See Publication 939 and Rev. Proc. 2005-8).

The Burns have $10,000 of taxable pension distribution that must be reported.

<u>Line 17</u> <u>Rental Real Estate, Etc.,</u> -

The Burns have three sources of rental income (loss) and must complete the following:

1. *Schedule E (Supplemental Income and Loss) to report the 4-plex, the limited partnership and the limited liability company information;*

2. *Form 8582 (Passive Activity Loss Limitations) to calculate the allowable passive activity losses.*

The passive activity loss is the amount by which the total losses from all passive activities for the tax year exceed the total income from all passive activities for the tax year. However, §469(k) requires the taxpayer to treat each publicly traded partnerships as a separate “activity” for purposes of the passive loss rules, so that the taxpayer will, in effect, be able to deduct losses from a publicly traded partnership only against income from that same partnership.

<u>Line 18</u> <u>Farm Income or (Loss)</u> - See "Country Mouse" outline.

<u>Line 19</u> <u>Unemployment Compensation</u> - All unemployment compensation is taxable to the taxpayer receiving it. However, there is an exception if the taxpayer repaid some of the unemployment compensation received. The unemployment compensation is reported on Form 1099-G.

<u>Line 20</u> <u>Social Security Benefits</u> - Social Security Benefits are reported to the taxpayer on Form SSA-1099. (Or the equivalent Railroad Retirement Benefits on Form RRB-1099). Up to 85% of Social Security Benefits may be taxable. Once the taxpayer has over $32,000 (if married filing jointly) or $25,000 (if single) of Modified Adjusted Gross Income, the Social Security Benefits start to become taxable. The taxable amount can be figured on the Worksheet on page 27 of the Form 1040 Instructions.

Since 2000, the earnings test for Social Security recipients between the ages of 65 and 69 has been abolished. Recipients between the ages of 62 and 64 are still under the test and for 2008, must repay $1 for every $2 over $13,560 of earned income.

<u>Line 21</u> <u>Other Income</u> - Includes all taxable income not otherwise reportable on the Form 1040 lines 7 through 20.

In <u>Bunker v. Comm'r</u>, T.C. Summ. Op. 2005-35, the Tax Court held that payments made on the taxpayer’s behalf by his credit card insurance policies, after the taxpayer lost his job and was unable to pay the credit card balances, were income from the discharge of indebtedness.

The Burns’s "other income" consists of $6,000 of casino winnings.

Proceeds from gambling winnings are reported on line 21. The taxpayer must report the total amount of winnings on line 21. All gambling losses, if any, are reported as an itemized deduction on Schedule A, line 28. The losses are reportable only to the extent of gambling winnings.

In Petty v. Comm'r., TC Memo 2004-144, the Tax Court agreed with the IRS that gambling winnings are included in the Modified Adjusted Gross Income calculation for purposes of the Earned Income Credit computation.

In Lindsey v. Comm'r, 422 F.3d 684 (8th Cir. 2005) the 8th Circuit Court of Appeals ruled that the taxpayer's receipt of damages to his emotions, reputation and character were not excludable from gross income as damages for personal physical injuries or physical sickness.

KETRA-2005 makes discharge of indebtedness income nontaxable for victims of Hurricane Katrina whose principal residence was in the "core" disaster area and suffered an economic loss. This applies to nonbusiness debt discharged between August 25, 2005 and January 1, 2007.

C. ADJUSTMENTS TO INCOME

Line 23 — Educator Expenses – On December 20, 2006, the president extended the above-the-line deduction for expenses incurred by eligible educators. An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide who worked in a school for at least 900 hours during a school year.

An eligible educator may deduct up to $250 of qualified expenses paid during the tax year. If taxpayers are married filing jointly and both taxpayers are eligible educators, each taxpayer may deduct up to $250 each of qualified expenses, with a maximum deduction of $500.

Expenses in excess of $250 may be deductible on Schedule A, line 21.

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Stacey had $1,450 of qualified expenses that are reported on Form 1040.

Line 24 — Business Expenses for Reservists, Performing Artists and Fee basis Gov't Officials - This includes deductions for (1) certain expenses incurred by National Guard and reserve members who travel more than 100 miles from home to perform Guard and reserve duties; (2) performing arts-related expenses, and (3) business expenses of fee based state or local government officials.

Line 25 — Health Savings Account – This deduction was created by the Medicare Prescription Drug Improvement and Modernization Act of 2003. HSAs are the successor to the MSA program.

Walter contributed $2,100 into his Health Savings Account in 2008. See Form 8889.

Those with an MSA are allowed to maintain them or convert them to an HSA. The following table describes the differences between an MSA and an HSA. (See IRS Notice 2004-50 for a detailed Q&A regarding HSAs as modified by Notice 2008-52.)

	Health Savings Account (HSA)	Medical Savings Account (MSA)
Eligibility	Individuals and any size group	Self-employed individuals and groups of up to 50
Maximum Contributions	The lesser of deductible or $2,900 for singles and $5,800 for families	Up to 65% of the single (max of $1,885) and 75% of the family (max of $4,350) deductible
Additional Contribution Allowance	Additional contributions allowed for age 55 and older. ($900 in 2008)	No
Eligible Contributors	Individuals, employers or employees	Self-employed individuals, employers or employees
Tax Deductibility (Employer)	Contributions are Tax deductible	Contributions are Tax deductible
Tax Deductibility (Employee)	Contributions may be either pre-tax if offered through a cafeteria plan or above the line tax deduction	Contributions are Tax deductible
Fund or Account Ownership	Employee	Employee
Portable	Yes	Yes
Rollover of Funds	Yes	Yes
Funding Required	Yes	Yes
Plan Types	High deductible health plan w/o co-pay	High deductible health plan w/o co-pay
Deductibles Singles (2007)	$1,100 minimum	$1,950 - $2,900
Deductibles Families (2007)	$2,200 minimum	$3,850 - $5,800
Out-of-Pocket Maximum	Singles - up to $5,600 Families - up to $11,200 (includes deductible but not out-of-network costs)	Singles - up to $3850 Families - up to $7,050 (includes deductible and out-of-network costs)
Drug Co-pay Allowed	No	No
Administration	Insurance company, TPA or bank	Insurance company, TPA or bank
Withdrawals for Non-qualified Medical Expenses	Taxable and subject to 10% penalty (no penalty for over 65)	Taxable and subject to 15% penalty (no penalty for over 65)

Line 26 — Moving Expenses - If a taxpayer moves for employment reasons, either a transfer or new job, certain moving expenses are deductible. The first qualification is that the new work site must be at least 50 miles from the old residence. In 1994, moving expenses became an above-the-line deduction, but what qualifies as deductible moving expenses was greatly reduced.

Line 27 — One-half of Self-employment Tax - A deduction consisting of one-half of self-employment tax is allowed as an above the line deduction. *See Form SE for further analysis, from Walter's and Stacey's businesses.*

Line 28 — Self-Employment SEP, SIMPLE and Qualified Plans - A sole proprietor is capable of making contributions to a plan in a dual capacity as employer and employee. This is relevant under both defined benefit and profit sharing pension plans.

In general, the rules for establishing a retirement plan for a self-employed individual are the same as the rules for other employers. For retirement plan purposes a self-employed individual is treated as both an employee and employer. The individual's contributions are limited to a percentage of his or her "earned income". In calculating earned income, however, a deduction must be taken for the individual's contribution to the retirement plan. The maximum deduction for a contribution to a profit-sharing plan is 15% divided by 1.15, or 13.0435%.

IRS Notice 2005-75 has increased many of the contribution limitations. The limitation on the annual benefit under a defined benefit plan increased to $175,000. The limitation for defined contribution plans increased to $44,000. Further, EGTRRA has statutorily increased other limitations. The limitation on the exclusion for elective deferrals for Section 402(g)(3) is $15,000. The limitation regarding SIMPLE retirement accounts remains at $10,000. The limitation on deferrals concerning deferred compensation plans of state and local governments and tax-exempt organizations is $15,000. The dollar limitation for catch-up contributions to an applicable employer plan other than a plan described in section 401(k)(11) or 408(p) for individuals aged 50 or over is increased to $5,000. The dollar limitation for catch-up contributions to an applicable employer plan described in section 401(k)(11) or 408(p) for individuals aged 50 or over is increased to $2,500.

Line 29 — Self-employed Health Insurance Deduction - Under the Tax and Trade Relief Extension Act of 1998, self-employed individuals are now able to deduct 100% of medical insurance and qualified long-term care insurance premiums paid during the tax year. (IRC §162(l)(1)(B)).

Walter paid premiums of $2,689 for the family high deductible health plan in 2008. Walter also paid premiums of $365 and Stacey paid $330 for qualified long-term care insurance policies (reduced to the allowable limit of $280 per taxpayer; see limitations in Schedule A comments below) for a total of $3,249. **(FORM 1040, LINE 29).**

Line 30 Penalty on Early Withdrawal of Savings - These penalties that a taxpayer was charged for early withdrawal should be reported on Form 1099-INT or 1099-OID.

Line 31 Alimony Paid - Payments of alimony under a divorce or separation order are generally deductible. The issue to be decided is whether the payments are actually alimony or a disguised property settlement.

Line 32 IRA Deduction - With the passage of the Taxpayer Relief Act of 1997 and the "corrections" contained in the IRS Restructuring and Reform Act of 1998, there were substantial changes to the IRA rules. From increasing the eligibility to creating an entirely new form of Individual Retirement Account (the Roth IRA), these two acts dramatically changed the IRA landscape.

Generally, in 2008 individuals can contribute up to the lesser of earned income or $5,000 annually. Additionally, a spouse can contribute up to $5,000 even if that spouse has no earned income. This is increased to $6,000 if age 50 or older at the end of 2008. Contributions can continue until the taxpayer reaches 70½. At age 70½, the taxpayer must begin taking minimum distributions.

The following chart details the deductibility of IRA contributions and phase-out limitations for 2008:

	Single or Head of Household	**Married Filing Joint**		**Married Filing Separate**
	Taxpayer	**Wife**	**Husband**	**Wife**
Single and not covered by employer plan	Fully Deductible	N/A	N/A	N/A
Single and covered by plan	Fully Deductible with $53,000 or less MAGI. Phase - out up to $63,000	N/A	N/A	N/A
Married and neither covered by employer plan	N/A	Fully Deductible	Fully Deductible	Fully Deductible IF did not live with spouse
Married and wife covered by employer plan	N/A	Fully Deductible with $85,000 or less MAGI. Phase-out up to $105,000	Fully Deductible with $159,000 or less MAGI. Phase - out up to $169,000	Partially Deductible. Phase – out up to $10,000 MAGI
Married and both covered by employer plan	N/A	Fully Deductible with $85,000 or less MAGI. Phase-out up to $105,000	Fully Deductible with $85,000 or less MAGI. Phase-out up to $105,000	Partially Deductible. Phase – out up to $10,000 MAGI

Even if the IRA contribution is not deductible, the taxpayer may still make a non-deductible IRA contribution or a Roth IRA contribution of the lesser of earned income or $5,000. The taxpayer MUST file Form 8606 for nondeductible IRA contributions. For more information see IRS Publication 923.

Roth IRA The Roth IRA does not create deductions upon contributions, but the distributions are tax-free if made after five years of the initial contribution to the Roth IRA, if the taxpayer is at least 59 ½, or because of death, disability, or to pay for certain first-time home buyer expenses.

The amount of allowable contributions to a Roth IRA is the lesser of $5,000 or the annual compensation. However, the combined amount of contributions to a traditional IRA and a Roth IRA cannot exceed the $5,000 ceiling. The allowable contributions are also subject to phase-out rules. The phase-out rules are as follows:

Filing Status	Full $5,000 Contribution	Partial Contribution	No Contribution
Married Filing Joint	AGI of $159,000 or less	AGI between $159,000 and $169,000	AGI above $169,000
Single or Head of Household	AGI of $101,000 or less	AGI between $101,000 and $116,000	AGI above $116,000
Married Filing Separate*	N/A	AGI between $1 and $10,000	AGI above $10,000

* If the taxpayers did not live together during the entire tax year, they are treated as single.

EGTRRA 2001 also allows taxpayers, who have reached age 50 by the close of the tax year, to make an additional $1,000 “catch-up” contribution for 2008 and thereafter. (See IRC §219(b)(5)(B)(ii)).

A taxpayer is allowed to continue making contributions to a Roth IRA even after reaching age 70 ½. Annual contributions can be made at any time up to the due date of the taxpayer’s return (not including extensions).

Rollover to a Roth IRA An existing traditional IRA can be rolled over or converted into a Roth IRA. There are three ways of rolling or converting a traditional IRA to a Roth IRA:

1. an ordinary distribution from the traditional IRA is contributed to a Roth IRA within 60 days after the distribution (normal withholding requirements will be required as for any ordinary distribution) (minimum required distributions do not qualify);

2. the traditional IRA can be transferred directly to a Roth IRA in a trustee to trustee transfer;

3. the trustee of the traditional IRA can directly transfer the amount to a Roth IRA.

The entire amount in the traditional IRA need not be transferred; partial transfers are acceptable.

However, a taxpayer’s AGI must not exceed $100,000 (not including minimum distributions from a traditional IRA or the taxable amount of the rollover / conversion) to be eligible to roll or convert these funds over (set to expire after 2009). Additionally, married taxpayers filing separate returns are not eligible to roll or convert these funds over.

An inherited IRA cannot be converted to a Roth IRA because it cannot be rolled over. PLR 200013041.

The taxpayer must include in gross income any amount which would be included if the distribution had not been rolled or converted to a Roth IRA. There is no early withdrawal penalty, however upon a rollover or conversion.

Recharacterizing IRA Contributions and Conversions: A taxpayer that converts from an IRA to a Roth IRA during any tax year and then reconverts it back to a traditional IRA via recharacterization may not reconvert that amount from the traditional IRA to a Roth IRA before the beginning of the tax year following the tax year in which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on which the taxpayer transfers the amount from the Roth IRA back to a traditional IRA by means of recharacterization.

The useful application of this recharacterization provision is when a taxpayer who converted a traditional IRA to a Roth IRA now experiences a decline in the value of the assets held by the Roth IRA.

To make a recharacterization the taxpayer must follow the instructions in Form 8606.

ACJA-2004 now allows an IRA or Roth IRA to own stock in a bank operated as an S-corporation.

The Form 1040 instructions contain the following helpful worksheet to calculate the deductible IRA contribution with these new restrictions and increased limitations:

> *Walter was not covered by an employer plan, thus he made a Traditional IRA contribution of $5,000 while Stacey made a Roth IRA contribution of $5,000. See attached IRA Deduction Worksheet.*

Line 33 — Student Loan Interest Deduction - The qualified student loan interest that may be deducted as an above-the-line deduction is $2,500.

This deduction phases out ratably for single taxpayers with modified AGI between $55,000 and $70,000 and for married taxpayers with modified AGI between $115,000 and $145,000. Married taxpayers must file a joint return to utilize this deduction. The modified AGI is the taxpayer's AGI without regard to the deduction for student loan interest or the exclusion for U.S. Saving Bond interest, adoption benefits, foreign possession and Puerto Rico income. The taxpayer claiming the deduction cannot be claimed as a dependent on another's tax return.

The qualifications for student loan interest deduction are as follows:

1. Qualified Student Loan - A loan to pay qualified higher education expenses for the taxpayer, spouse, or dependent when the loan was taken out. The proceeds must have been used for qualified higher education expenses and the loan cannot come from a related person or through a qualified employer plan.

2. Qualified Higher Education Expense - These include tuition, fees, room and board, books and supplies. The expenses must be incurred for a degree, certificate or similar program at an eligible educational institution. (Colleges, universities, and certain vocational schools).

3. Eligible student - A person who is enrolled in a degree, certificate, or other program approved for credit by the institution and must carry at least half the full-time work load for the course study.

The Burns paid a total of $2,338 of student loan interest in 2008. Their deduction is reduced because of the phase out limitations. (See worksheet).

Line 34 — Tuition and Fees Deduction – This deduction was extended by the Emergency Economic Stabilization Act (P.L. 110-345) through December 31, 2009. The maximum amount deductible for 2008 is $4,000 for taxpayers with an adjusted gross income at or below $65,000 ($130,000 for married filing joint). Taxpayers with an adjusted gross income above $65,000 but less than $80,000 (above $130,000 but less than $160,000 for married filing joint) may deduct a maximum of $2,000.

This deduction may not be taken if the taxpayer has claimed the Hope Scholarship credit or Lifetime Learning credit.

Stacey paid $645 of qualified tuition fees in 2008. Stacey has an option here.

Line 35 — Domestic Production Activities Deduction – The taxpayer, who generates income from domestic production activities, and pays wages, may be entitled to a deduction of up to 6% of their qualified production activities income. See Form 8903.

Stacey's candle business generates qualified production activities income. See Form 8903 for details.

Line 36 — Other Adjustments. The instructions to Form 1040 include the following other adjustments to AGI that are reported on the dotted line next to line 36:

a. Deductible expenses related to income reported on line 21 from the rental of personal property engaged in for profit (“PPR”).

b. Reforestation amortization and expenses (“RFST”).

c. Repayment of supplemental unemployment benefits under the Trade Act of 1974 (“Sub-Pay TRA”).

d. Contributions to §501(c)(18)(D) pension plans (“501(c)(18)(D)”).

e. Contributions by certain chaplains to section 403(b) plans (“403(b)”).

f. Attorney fees and court costs for actions settled or decided after October 22, 2004, involving certain unlawful discrimination claims ("UDC") but only to the extent of gross income from such action. See AJCA-2004.

g. Deduction for clean-fuel vehicles (“Clean-Fuel”).

The Clean-Fuel Vehicle Deduction (IRC §179A) from The Energy Policy Act of 1992 is available for taxpayers who purchase vehicles that utilize “clean fuels” such as natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel that is 85% or more alcohol or ether. WFTRA-2004 eliminated the partial phase-out of the deduction for 2005. The Energy Tax Incentives Act of 2005 has eliminated these deductions for the tax years beginning after December 31, 2005. Credits for placing those types of vehicles in service are now found in IRC §30C.

III. FORM 1040 (Page Two) AND COMMENTARY

A. DEDUCTIONS (Lines 39 and 40)

An individual may deduct the larger of (a) itemized deductions (Schedule A), or (b) the standard deduction. (See Code §63).

1. Standard Deduction. The Standard Deduction for 2008 for the applicable filing status is as follows (See Rev. Proc. 2007-66):

a.

Filing Status	Under 65 and not Blind
Single	$5,450 (up from $5,350 in 2007)
Married Filing Joint	$10,900 (up from $10,700 in 2007)
Married Filing Separate	$5,450 (up from $5,350 in 2007)
Head of Household	$8,000 (up from $7,850 in 2007)

plus

b. An additional amount will be allowed if the taxpayer is age 65 or older or is blind on the last day of the tax year.

For single/head of household filers, the amount is $1,350, while for married filing joint, the amount is $1,050.

WFTRA-2004 gave further marriage penalty relief by keeping the married filing joint standard deduction at 200% of the single standard deduction for 2005 through 2010.

2. Tax Planning Point: If your average itemized deductions approximately equal the standard deduction, the strategy of "bunching" should be implemented. This strategy allows you to take the standard deduction one year and itemize the next. An example demonstrates how bunching works.

Example: A single taxpayer with constant expenses from year to year as follows:

Mortgage Interest	$3,000
Medical (Deductible portion)	$800
State and local taxes	$1,000
Charitable Contributions	$1,250
TOTAL	$6,050

That is enough to itemize, but the taxpayer loses the standard deduction, which is $5,350 for 2007. Over two years the taxpayer would be entitled to deduct $12,100, but that is it.

Bunching allows the taxpayer to adjust the timing of expenses so they are low in one year and high in the next. Following this strategy, the taxpayer can make the following adjustments:

(1) In even years prepay January interest in December.
(2) See the doctor/dentist in January, June, and December in even years and June in odd years.
(3) In even years prepay property taxes due in the following year.
(4) Plan large charitable gifts for even years.

Following this strategy, you end up with the following expenses:

	ODD	EVEN
Mortgage interest	$2,800	$3,200
Medical	400	1,200
State and local taxes	600	1,400
Charitable contributions	500	2,000
TOTAL	$4,300	$7,800

The total is the same: $12,100 for two years, but by bunching the expenses, the taxpayer gets $7,800 of itemized deductions in the event year and at least a standard deduction for the odd year ($5,150 in 2007). Total: $12,950.

Due to the 2% floor, another means of preserving itemized deductions would be to wait for a low income year. This can be an effective tax planning tool for individuals with fluctuating annual income. For example, if in 2007 you earn a $1 million dollar salary, you may want to move itemized deductions into the following year when you expect to earn only an $80,000 salary.

3. Itemized Deduction:

Substantiation of Deductions. The IRS has issued guidelines where substantiation other than by canceled check will be acceptable. Rev. Proc. 92-71, IRB 1992-35. They are as follows:

a. Bank Statements, if they show: the check number; the amount of the check; the date the check amount was posted to the account by the financial institution; and the name of the payee.

b. Electronic Funds Transfer (shown on bank statement), if they show: amount of the transfer; date the transfer was posted to the account by the financial institution; and the name of the payee.

c. Credit Card Statements, if they show: the amount of the charge; the date of the charge (transaction date); and the name of the payee.

For examples of unacceptable substantiation, see Jones v. Comm'r, TC Memo 1992466 (8/18/92).

On the example tax return, the Burns will itemize their deductions. (See Schedule A.)

B. EXEMPTIONS (Line 42)

The deduction for personal exemptions has increased $100 from last year, to $3,500 for 2008. Children who can be claimed (whether or not they are) as dependents on the parents' return cannot claim themselves on their own returns. See Code § 151(d).

If the taxpayer's AGI exceeds a threshold amount (based upon filing status) the deduction for exemptions is reduced by 2% for each $2,500, (or each $1,250 for married filing separately), or fraction thereof, by which the AGI exceeds the threshold amount. (See Code §151(d)(3)). The 2008 exemption amount for taxpayers with AGI in excess of the maximum phase out amount is $2,333. The threshold amounts for 2008 are:

Filing Status	AGI Threshold	Exemptions Lost When AGI Equals
Joint Returns and Surviving Spouse	239,950	362,450

Head of Household	199,950	322,450
Single Taxpayers	159,950	282,450
Married Filing Separately	119,975	181,225

KETRA-2005 allows a taxpayer to claim an additional $500 per person (up to a maximum of $2,000) exemption for providing housing to a person who was displaced from their main home due to Hurricane Katrina if the following apply:

1. The person displaced lived with the taxpayer for at least 60 consecutive days;
2. The taxpayer did not receive any remuneration;
3. The displaced person's main home was, on August 28, 2005, in the Hurricane Katrina disaster area;
4. The displaced person was not the taxpayer's spouse or dependent.

The phase-out limits that apply to ordinary personal exemptions do not apply to this new provision. This deduction is computed on new IRS Form 8914.

The Burns' AGI does not exceed the $239,950 threshold and therefore their exemptions will not be reduced.

C. TAX RATE (Line 44)

Rev. Proc 2007-66 has adjusted the tax tables for 2008 as follows:

MARRIED, FILING JOINTLY

Taxable Income		Tax
Over	But Not Over	
$0	$16,050	10%
$16,050	$65,100	$1,605 + 15% of amount over $16,050
$65,100	$131,450	$8,962.50 + 25% of amount over $65,100
$131,450	$200,300	$22,550 + 28% of amount over $128,500
$200,300	$357,700	$44,828 + 33% of amount over $200,300
$357,700	_____	$96,770 + 35% of amount over $357,700

SINGLE

Taxable Income		Tax
Over	But Not Over	
$0	$8,025	10%
$8,025	$32,550	$802.50 + 15% of amount over $8,025
$32,550	$78,850	$4,481.25+ 25% of amount over $31,850
$78,850	$164,550	$16,056.25 + 28% of amount over $78,850
$164,550	$357,700	$40,052.25 + 33% of amount over $164,550
$357,700	_____	$103,791.75 + 35% of amount over $357,700

On the example tax return, the Burns have capital gain and qualified dividend income and will therefore calculate their federal income tax by using the Qualified Dividends and Capital Gains Tax Worksheet found in the Form 1040 Instructions for Line 44.

WFTRA-2004 has extended the 10% tax bracket through the year 2010 and eliminated the marriage penalty in the 15% bracket for married filing joint equal to 200% of filing single 15% bracket for the 2004-2010 tax years.

D. ALTERNATIVE MINIMUM TAX (Line 45)

The Taxpayer Relief Act of 1997 changed how AMT is calculated. The tax rate for the taxpayer, other than a corporation, is 26% and a 28% AMT tax bracket is added to AMT incomes in excess $175,000. The AMTI exemptions for 2008 are $69,950 (married filing joint) or $46,200 (single). The capital gains rates are applied to the AMT rules on Part IV of Form 6251.

AJCA-2004 now allows farmers and fishermen who utilize income averaging to compute their regular tax without the income averaging in calculating their AMT liability.

The following types of interest deductions are added back to the tax base for computing the alternative minimum tax:

1. The deduction for personal interest that is allowed under the five-year phase out;

2. The deduction for home mortgage interest to the extent that the mortgage loan was not incurred in acquiring, constructing, or substantially rehabilitating your home; and

3. The deduction for investment interest in excess of net investment income that is allowed under the five-year phase out. § 56(b)(1)(c).

4. The deduction for passive losses in excess of income from passive activities that is allowed under the phase-in rules of the Act must also be added back to the tax base to calculate alternative minimum tax.

If a taxpayer uses the standard deduction for regular tax purposes, the taxpayer cannot elect to use itemized deductions for the AMT calculation. PLR 200103073.

The exemption amounts are phased out by $0.25 for each $1.00 that alternative minimum taxable income exceeds $150,000 (married filing joint) or $112,500 (single), until the exemption amounts are completely phased out. §55(d)(3).

The alternative minimum tax rate is 26% on the first $175,000 of AMTI (less exemptions) and 28% on any excess AMTI (less exemptions). §55(b).

Based on the worksheet, the Burns are not required to complete Form 6251 to determine if they will owe alternative minimum tax.

E. CREDITS (Lines 47-55)

1. Credit for Child and Dependent Care Expenses (Line 48) This credit is available for taxpayers who pay someone to care for their child or dependent, in order to be employed themselves, this credit is available. The child must be under age 13 or disabled. The credit is calculated on Form 2441. The credit is based on the number of qualifying children, amount of qualifying expenses paid, and the income earned by the parent(s).

The Burns have paid two individuals for child care expenses and must file Form 2441 to claim the credit.

The maximum credit is 35% of the eligible expenses paid, the AGI phase-out threshold is $15,000 and the maximum eligible dependent care expense is $3,000 (for one child) and to $6,000 (for more than one child). The $6,000 expense limit for two or more children does not have to be split evenly between the children.

2. Credit for the Elderly or the Disabled (Line 49) For taxpayers that are, at the end of 2007 (a) 65 or older, or (b) retired on permanent and total disability and had taxable disability income, there is a credit allowed. AGI must be less than $17,500; $20,000 if married filing joint and only one spouse is eligible; $25,000 if both are eligible; and $12,500 if married filing separate. The IRS can calculate this credit for the taxpayer. See Schedule R for details.

3. Education Credits. (Line 50) The education credit is equal to the sum of the Hope Scholarship Credit which is up to $1,800 per year per student; and the Lifetime Learning Credit which is up to $2,000 per year per taxpayer. These credits are for expenses paid for higher education at accredited post secondary education institutions. These expenses may be incurred by the taxpayer, their spouse, or for a dependant.

   The Hope Scholarship Credit is available for the first two years of undergraduate education. The Lifetime Learning Credit is for any post high school education at an eligible educational institution. Both of these credits cannot be claimed in the same year with respect to a single student. Married taxpayers must file jointly to be eligible for this credit.

   For joint tax returns, these credits are phased out with modified adjusted gross income between $96,000 and $116,000. The phase out range is $48,000 to $58,000 for single taxpayers.

   FSA 200236001 may give higher income individuals an ability to get the advantage of the HOPE or Lifetime Learning Credits. When a student can be claimed on a parents' return, but the parents do not claim the student, or their exemption is completely phased out due to high income, the student, assuming they have sufficient income in their own right, can claim the credits because their dependency exemption is not claimed on their parents' return.

   Also, the taxpayer is able to take an education credit the same year they received a distribution from an Education Savings Account.

Stacey continued her Masters program in 2008 and paid $645 of tuition. However, because their AGI is more than $116,000 she claimed the deduction on Form 2106.

4. Residential Energy Credits (Line 53) The following credits are computed on Form 5695 and were added by the Energy Tax Incentives Act of 2005 and expired at the end of 2007, but were extended through 2016 pursuant to the Emergency Economic Stimulus Act of 2008:

   a. Residential Energy Efficient Property credit - 30% of the cost of eligible solar water heaters, solar electricity equipment and fuel cell plants placed in service in 2008 is eligible for the credit. The maximum credit is $2,000 per year for each category of solar equipment and $500 for each half kilowatt of capacity of fuel cell plants installed per tax year. See I.R.C. § 25D.

   b. Non-Business Energy Property Credit – the credit is equal to expenses incurred to add energy efficient property, plus 10% of qualified energy efficient improvements. The credit is limited to a lifetime maximum of $500 for added insulation, exterior doors and windows, and metal roofs coated with heat-reducing pigments, main air circulating fans, furnaces, hot water heaters, heat pumps and central air conditioners. See I.R.C. § 25C.

5. Foreign Tax Credit (Line 47) This credit is based on taxes paid to foreign countries for income generated therefrom. The credit is computed on Form 1116.

6. Retirement Savings Contributions Credit. (Line 51) This tax credit is computed using Form 8880. This is a credit for eligible taxpayers who made:

   a. Contributions to a traditional or Roth IRA.

   b. Elective deferrals to a 401(k), 403(b), 457, SEP, or SIMPLE plan.

   c. Voluntary contributions to a qualified retirement plan.

   d. Voluntary contributions to a 501(c)(18)(D) plan.

   To be eligible, the taxpayer must be 18 or older and not a student. The credit is phased out for single taxpayers at $26,500 of AGI, $39,750 for head of household and $53,000 for married filing joint. The credit can be up to 50% of the lesser of $2,000 or the amounts contributed by the taxpayer into the retirement savings discussed above. IRS Announcement 2001-106 contains the following chart to determine the credit:

Married filing joint	Head of household	All other filers	Credit
$0 - $32,000	$0 - $24,000	$0 - $16,000	50% of contribution
$22,000 - $34,500	$24,000 - $25,875	$16,000 - $17,250	20% of contribution
$34,500 - $53,000	$25,875 - $39,750	$17,250 - $26,500	10% of contribution
Over $53,000	Over $39,750	Over $26,500	credit not available

6. Child Tax Credit. (Line 52) JGTRRA increased the amount qualifying taxpayers can claim as a tax credit for each qualifying child under the age of 17 to $1,000. Additionally, WFTRA-2004 extended the $1,000 credit (which was scheduled to be reduced beginning in 2005) through 2010. (See Child Tax Credit Worksheet beginning on page 42 of the Form 1040 instructions).

   The child tax credit is reduced by $50 for each $1,000 of modified AGI in excess of $110,000 for married filing joint, $75,000 for single and head of household and $55,000 for married filing separately. The phase out range depends upon the number of qualifying children.

To be eligible for the Child Tax Credit, the qualifying child (for purposes of the dependency deduction) must be: (1) claimed as a dependent; (2) under the age of 17; and (3) a U.S. citizen, U.S. national, or a resident of the U.S. (or an adopted child that lived with the taxpayer all year).

Additionally, under MFTRA-2003, combat-zone compensation is considered to be "earned income" for purposes of the Child Tax Credit.

Walter and Stacey have two qualifying children. Additionally, their modified AGI is in excess of $110,000. Therefore, they must use the worksheet from Publication 972 to calculate their 2007 Child Tax Credit.

7. <u>Adoption Credit. (Line 53)</u> The credit is allowed for qualified adoption expenses paid by the taxpayer during the tax year. The credit is computed on Form 8839.

   For 2008, the maximum credit is increased for inflation to $11,650 per child. This credit also has a phase out component, which has been increased for inflation for 2008, for modified AGI's between $174,730 and $214,730.

   a. Domestic Adoption

      (1) For expenses paid before the year the adoption becomes final, the credit is allowed in the year after the year the expenses were paid.

      (2) When expenses were paid during or after the year the adoption becomes final, the credit is allowed for that year. If expenses are paid in an unsuccessful adoption attempt, the credit is allowed in the next taxable year.

   b. Foreign Adoption - The credit for expenses paid for a foreign adoption is allowed in the year the adoption becomes final.

   The credit is a nonrefundable credit, however, the taxpayer may carry forward any unused credit through the succeeding five tax years after the year the credit arose.

   The term "qualified adoption expenses" is defined as the reasonable and necessary expenses directly related to legally adopting an eligible child. These expenses do not include a surrogate parenting arrangement or the costs of adopting a spouse's child.

"An eligible child" is a child under 18 or one who is incapable of caring for himself or herself.

A "child with special needs" is defined as a U.S. citizen or resident who the State has determined cannot or should not be returned to his or her parents residents, and who probably will not be adopted without assistance.

8. Mortgage Interest Credit (Line 53) This credit is allowed for first-time homebuyers whose income is generally below the median income in the area where the taxpayer lives. The credit is calculated on Form 8396.

9. Other Credits (Line 54) Other credits available for taxpayers include:

   a. Alternative minimum tax credit (calculated on Form 8801);

   b. Qualified electric vehicle credit (calculated on Form 8834). Credit is only applicable to property placed in service before December 31, 2006.

   c. General business credit (calculated on Form 3800);

   d. Energy efficient appliances – manufacturers producing energy efficient appliances are eligible for a new credit. This includes dishwashers, clothes washers and refrigerators. This credit is a part of the general business credit.

   e. Empowerment zone employment credit (calculated on Form 8844);

   f. Credit for alcohol used as fuel (calculated on Form 6478);

   g. Renewable electricity, refined coal, and Indian coal production credit (calculated on Form 8835)

   h. New York Liberty Zone business employee credit (see Form 8884 and Form 8835)

   i. Nonconventional Source Fuel Credit, (calculated on Form 8907);

   j. Qualified zone academy bond credit - for S-corporation shareholders (calculated on Form 8860)

F. OTHER TAXES (Lines 57-60)

1. Self-employment Tax (Line 57)

The Burns must file two Schedules SE due to Walter's and Stacey's self-employment income.

2. Social Security and Medicare Tax on Tip Income (Line 58) If the taxpayer received $20 or more of tips and did not report the full amount to the employer, or their W-2 shows allocated tips, the taxpayer must calculate the tax by using Form 4137.

3. Additional Tax on IRA's, other Qualified Plans, etc. (Line 59) This tax may be due if the taxpayer:

   a. Received any early distributions from (i) an IRA or other qualified retirement plan, (ii) an annuity, or (iii) a modified endowment contract entered into after June 20, 1988.

   b. Made excess contributions to IRAs, Coverdell education savings accounts (ESAs), Archer MSAs, or Health Savings Accounts.

   c. Received taxable distributions from Coverdell ESAs or qualified tuition programs.

   d. Was born before July 1, 1934, and did not take the minimum required distribution from their IRA or other qualified retirement plan.

   Form 5329 is used to calculate this tax unless item a. above applies **and** distribution code 1 is correctly shown in box 7 of Form 1099R. Instead, multiply the taxable amount of the distribution by 10% (.10) and enter the result on line 60. Also write “No” under the heading “Other Taxes” to the left of line 60.

   In Ahmad v. Comm'r, T.C. Summ. Op. 2005-103, the Tax Court upheld the assessment of the 10% penalty on a taxpayer’s early distribution from his Public Employees Retirement System account. The taxpayer argued that he qualified for an exception on the following grounds that (1) his divorce had caused him both financial and emotional hardship – the Tax Court ruled that was not a qualified exception; (2) he suffers from medical conditions – the Tax Court ruled that because he was working full time, he was not disabled; (3) he was enrolled as a student at a university – the Tax Court ruled that while IRA distributions may be used for higher education, distributions from a qualified retirement plan cannot, without the 10% penalty; and (4) his retirement account was marital property subject to division by the divorce court – the Tax Court ruled that marital settlement agreements do not qualify as a qualified domestic relations order to meet the penalty exception rule.

Walter received an early distribution from his 401(k), but because distribution code 1 was entered in box 7, he is not required to use Form 5329, but still must pay the 10% additional tax.

4. Advanced Earned Income Credit Payments (Line 60) The taxpayer receiving advanced earned income payments from an employer, reported in box 9 Form W-2, must report these amounts.

5. Household Employment Taxes (Line 60) A taxpayer who:

    a. Pays any one household employee cash wages of $1,600 or more in 2008; or

    b. Withholds Federal Income Tax during 2008 at the request of a household employee; or

    c. Pays total cash wages of $1,000 or more in any calendar quarter of 2007 or 2008 to household employees

    must file Schedule H along with their Form 1040, or by itself if they are not required to file a Form 1040.

On the example tax return, the Burns have a household employee who they paid more than $1,600 in 2008, and must complete Schedule H.

6. Total Tax. (Line 61) The following additional taxes should be reported on the dotted line and included in line 61:

    a. Additional tax on health savings account distributions (see Form 8889). Identify as "HSA." Additional tax on HSA because taxpayer did not remain an eligible individual during the testing period (Form 8889, Part III) identify as “HDHP”.

    b. Additional tax on Archer MSA distributions (see Form 8853). Identify as "MSA."

    c. Additional tax on Medicare Advantage MSA distributions (see Form 8853). Identify as "Med MSA."

    d. Recapture of the following credits:

        i. Investment credit (see Form 4255). Identify as "ICR."
        ii. Low-income housing credit (see Form 8611). Identify as "LIHCR."
        iii. Qualified electric vehicle credit (see Pub. 535). Identify as "QEVCR."
        iv. Indian employment credit (see form 8845). Identify as "IECR."

v. New markets credit (see Form 8874). Identify as "MNCR."
vi. Credit for employer-provided child care facilities (see form 8882). Identify as "ECCFR."

e. Recapture of federal mortgage subsidy. If you sold your home in 2008 and it was financed (in whole or in part) from the proceeds of any tax-exempt qualified mortgage bond or you claimed the mortgage interest credit, see Form 8828. Identify as "FMSR."

f. Section 72(m)(5) excess benefits tax (see Pub. 560). Identify as "Sec. 72(m)(5).:

g. Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance. This tax should be shown in Form W-2, box 12, with codes A and B or M and N. identify as "UT."

h. Golden parachute payments. If you received an excess parachute payment (EPP), you must pay a 20% tax on it. This tax should be shown in Form W-2, box 12, with code K. If you received a Form 1099-MISC, the tax is 20% of the EPP shown in box 13. Identify as "EPP."

i. Tax on accumulation distribution of trusts (see Form 4970). Identify as "EPP";

j. Excise tax on insider stock compensation from an expatriated corporation. You may owe a 15% excise tax on the value of nonstatutory stock options and certain other stock-based compensation held by you or a member of your family from an expatriated corporation or its expanded affiliated group in which you were an officer, director, or more-than-10% owner. See Internal Revenue Code section 4985. Identify as "ISC."

k. Additional tax on income you received from a nonqualified deferred compensation plan that fails to meet certain requirements. This income should be shown in Form W-2, box 12, with code Z, or in Form 1099-MISC, box 15b. See Internal Revenue Code section 409A(a)(1)(B) to figure the tax on this income. Identify as "NQDC.)

l. Interest on the tax due on installment income from the sale of certain residential lots and timeshares. Identify as "453(l)(3): or "453A(c)," whichever applies.

G. <u>PAYMENTS</u> <u>(Lines 64-70)</u>

1. <u>Federal Income Tax Withheld (Line 62)</u>. Using Form W-4V, taxpayers may request voluntary withholding on amounts received after 1996 on

the following types of payments: (a) social security benefits; (b) crop disaster payments; (c) commodity credit corporation loans; (d) state unemployment compensation benefits; and (e) other federal payments specified by the IRS. See Code § 3402(p).

Walter had $2,000 withheld from the 401(k) distribution; Stacey had $3,115 withheld from her W-2.

2. 2008 Estimated Tax Payments (Line 63): To Make or Not to Make. Due to the considerable complexity of some estimated tax computations, especially relating to high-income taxpayers, preparers may often be asked if it might be prudent to avoid paying the estimates altogether.

   This may be especially true where the taxpayer is short of cash. In addition, because the estimated tax penalty is simply an interest calculation on the unpaid amount, it may be economically correct to avoid the payment where the IRS interest is no higher than the taxpayer's prospective loan rate. This is also true where the taxpayer can earn a rate higher than the IRS would charge by investing the estimate payment.

   The danger with such an approach is the operation of Code Sec. 7203. This section makes it a misdemeanor for the taxpayer to willfully fail to make the required estimated tax payments, subject to a fine of up to $25,000 and/or one year in prison.

   While prosecution is certainly remote, it places the preparer in a rather precarious position of assenting to criminal conduct. Thus, every notification to the taxpayer of the potential liability should be made.

Walter also made estimated tax payments for the period he was self employed, totaling $20,000.

3. Earned Income Credit (Line 64(a)). The earned income credit is a refundable credit which is available to taxpayers with or without qualifying children. For tax year 2008, the following table from Rev. Proc. 2006-53 sets the limits on the credit as follows:

Number of Children	Maximum Amount of the Credit	Earned Income Amount	Single Threshold Phase-out Amount	Single Completed Phase-out Amount	Married/ joint threshold phase-out amount	Married/ Joint Completed Phase-out Amount
1	$2,917	$8,580	$15,740	$33,995	$18,740	$36,995
2 or more	$4,824	$12,060	$15,740	$38,646	$18,740	$41,646
None	$438	$5,720	$7,160	$12,880	$10,160	$15,880

The qualifying child for purposes of the earned income credit is one who:

a. is the taxpayer's son, daughter, adopted child, brother, sister, stepbrother, stepsister or a descendent of a child, stepchild, brother, sister, stepbrother, stepsister or foster child; and

b. was at the end of the tax year under age 19, or under age 24 and a student, or any age and permanent and totally disabled; and

c. lived with the taxpayer in the United States for more than half of the year. The exception to this qualification is when::

    i. The child was born or died in 2008; and

    ii. The taxpayer's home was the only home for the child while alive during 2008.

A child in prison during the tax year does not qualify as a dependent, or for purposes of the earned income credit, because the taxpayer (parent) was not required to support the child, the State was. See Haywood v. Comm'r., TC Memo 2002-258. The same holds true for a taxpayer whose children are in foster care. See Linton v. Comm'r., TC Memo 2003-160 (the head of household, dependency and earned income credit all disallowed).

Money earned by a taxpayer while incarcerated is not earned income for purposes of the earned income credit pursuant to IRC §32(c)(2)(B)(iv). Thus the taxpayer/inmate had no earned income and was not allowed an earned income credit for 1998 while she was in prison. Rogers v. Comm'r, T.C. Memo 2004-245.

Additionally, the earned income tax credit is denied if certain investment income exceeds $2,800 (increased from $2,700). (See Rev. Proc. 2005-70).

Under WFTRA-2004, “earned income” now includes combat zone compensation. (See Line 64b)

The earned income credit qualifications, calculations and worksheets can be found on pages 46 through 60 of the instructions to Form 1040

4. Excess Social Security and RRTA Tax Withheld (Line 65). The maximum amount of Social Security tax that may be withheld in 2008 is $6,324. If a taxpayer has more than one employer and combined they withhold more than this amount, the taxpayer is allowed to take the excess as a credit on line 65.

However, if a single employer withholds more than $6,324 of Social Security tax, the employer must refund the excess, it cannot be claimed as a credit on the Form 1040.

5. Additional Child Tax Credit (Line 66). The additional Child Tax Credit is a refundable portion of the Child Tax Credit calculated on line 52 of Form 1040. This credit is calculated using Form 8812.

6. Amount Paid With Request for Extension to File (Line 67). When filing a request for extension, the IRS may reject the request if the taxpayer's estimate of tax liability is found to be unreasonable. Any amounts paid with the filing of Forms 4868, 2688 or 2350 should be included on this line.

7. Other Payments (Line 68). Other payments may come from Forms 2439, 4136 or 8885.

8. First-time Homebuyer Credit (Line 69). First-time homebuyer credit applies to purchases after April 8, 2008, and before July 1, 2009, credit operates like an interest-free loan that must be repaid over 15 years. See IR. 2008-106. Maximum available credit is $7,500 for single or married filing joint.

H. ESTIMATED TAX PENALTY (Line 76) Individuals must pay a penalty on any underpayment of estimated tax. To avoid the underpayment of estimated tax penalty, individuals must pay 25% of a "required annual payment" of estimated tax by Apr. 15, June 15, Sept. 15, and Jan 15 (for calendar year taxpayers).

The estimated tax penalty is not imposed if the shortfall for the year is less than $1,000.

Underpayment penalties will not be imposed on individual taxpayers provided current year tax estimates are 100% of prior years tax and prior years AGI was $150,000 or less. As of January 1, 1994, if the prior years AGI was more than $150,000, a scheduled percentage of prior years tax must be paid. As of 2006, 110% of the prior years tax must be paid in estimated if the prior years AGI was more than $150,000. The alternate method of paying 90% of the current years tax is also acceptable.

1. **IRS Waiver of Penalty for Underpayment of Estimated Taxes.** The IRS may waive this penalty under Code Sec. 6654(e)(3)(A) where “by reason of casualty, disaster or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience.”

2. **Penalties.** With the continued increase in penalty exposure, the final regulations regarding the accuracy related penalties (negligence,

substantial understatement valuation misstatement) and the preparer penalties should be reviewed.

Because the IRS often miscalculates penalty amounts, it is necessary to examine the calculations they make. The methods used are discussed in the Consolidated Penalty Handbook, new part E & I of the Internal Revenue Manual.

3. **Interest on Overpayments of Tax.** No interest is paid by the IRS on a Refund arising from an original income tax return if the refund is issued by the 45th day after the later of the due date for the return or the date the return is filed. Rev. Rul. 2007-68 set the rate of interest for overpayments and underpayments beginning January 1, 2008 at 7%.

I. THIRD PARTY DESIGNATION The taxpayer designates a third party (but not necessarily the paid preparer) to discuss the return with the IRS. By checking the “yes” box, the taxpayer authorizes a designee to:

1. Give the IRS any information that is missing from the taxpayer’s return.

2. Call the IRS for information about the processing of the taxpayer’s return or the status of the refund or payments.

3. Receive copies of notices or transcripts related to the return, upon request.

4. Respond to certain IRS notices about math errors, offsets, and return preparation.

By checking this “yes” box, the taxpayer is not authorizing the designee to receive any refund check, bind the taxpayer to anything (including any additional tax liability), or otherwise represent the taxpayer before the IRS, a Form 2848 (IRS Power of Attorney) is still required for these matters.

This limited authorization automatically expires on the due date (April 16, 2009) of the taxpayer’s 2008 tax return. Also, the taxpayer can revoke the authorization before it expires if necessary. (See Publication 947).

J. PAID PREPARER’S RETENTION OF MANUALLY SIGNED RETURN COPIES

Final treasury regulations have been issued giving paid preparers two alternatives to the requirement that they retain the manually signed return (or a copy of thereof). Treas. Reg. §1.6695-1(b)(4)(i) allows the paid preparer to:

1. retain a photocopy of the manually signed copy of the return or claim for refund; or

2. use an electronic storage system meeting the requirements of Rev. Proc. 97-22, Sec. 4, 1997-1 CB 652, or procedures subsequently prescribed by IRS, to store and produce a copy of the return or claim manually signed by the preparer.

K. FORM 4868 PROVIDES 6 MONTH EXTENSION

Revised Form 4868 allows a taxpayer to file for and receive a 6-month extension on filing their individual income tax return. Before this revised form, a taxpayer was required to file Form 4868 to obtain a 4-month extension followed by a Form 2688 for an additional 2-month extension.

IV. ADDITIONAL FORMS & SCHEDULES WITH COMMENTARY

SCHEDULE A

1. Line 1 Medical and Dental Expenses

Taxpayers who itemized their deductions can deduct non-reimbursed medical and dental expenses, but the deduction is limited to the expenses that are more than 7.5% of the taxpayer's AGI.

Some applicable limitations on medical and dental expenses are: 1)standard mileage which has been increased for 2008 to $0.19 a mile during 2008; 2) $50/night limitation on lodging while away from home that is essential to and primarily for medical care provided by a physician in a hospital; 3) meals are subject to a 50% limitation.

In Rev. Rul. 2000-24, the IRS determined that the cost of travel to and attendance to a medical conference pertaining to the taxpayer's child's illness was a deductible medical expense under IRC §213. However, the lodging costs were not deductible.

Amounts paid by taxpayers for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care, subject to the 7.5 percent floor limitation. Rev. Rul. 2002-19.

Expenses of a nursing home, including meals and lodging, are deductible as a medical expense if they meet the requirements of Reg. 1.213-1(e)(1)(v). These include: (a) the individual is in the home because her condition is such that the availability of medical care is the principal reason for being in the nursing home; (b) meals and lodging are furnished as a necessary incident to the medical care; and (c) the meals and lodging are furnished to an individual who needs continual medical care.

See Rev. Rul.'s 2003-57 and 2003-58 for a variety of newly added medical expenses that qualify, and some that do not qualify as deductible medical expenses. For example: LASIK eye surgery qualifies, but teeth whitening procedures do not qualify.

Additionally, for tax years beginning after December 31, 1996, a taxpayer is allowed to deduct the costs of long-term care insurance. The limitations regarding long-term care premiums were changed for tax years beginning in 2007 in Rev. Proc. 2006-53 as follows:

Age of Taxpayer	Deductible Limit
0 to 40	310
41 to 50	580
51 to 60	1,150
61 to 70	3,080
71 +	3,850

Rev. Rul. 2003-43 allows employers who offer flexible spending arrangements or health reimbursement arrangements to their employees to provide the employee with credit or debit cards to be used by the employee to pay for their medical expenses. This can create substantial ease in the area of substantiation and reduce the paperwork involved in administering these arrangements.

The Burns had $1,854 of medical expenses, however, all of that was reimbursed through the Health Savings Account. Additionally, the health insurance premiums of $2,689 and the allowable $310 x 2 of Walter's and Stacey's long term care premiums were deducted above the line, as both Walter and Stacey have self-employment income. The Burns have no unreimbursed medical expenses to report on Schedule A.

2. Lines 5-9 Taxes Paid

This deduction includes state and local income taxes or state and local sales taxes, taxes paid on the taxpayer's real estate not used in a trade or business, personal property taxes, and other miscellaneous taxes paid during the tax year. The deduction for sales tax expired in 2005.

The taxes paid by the Burns in 2008 are as follows:

2008 State Income Taxes (W-2)	*$1,434*
2008 Estimated State Income Taxes	*$3,500*
Form 1099-R Withholding	*$600*
Real Estate Taxes: The amount of real estate taxes paid, $4,585	*$4,585*
Personal Property Taxes (auto license) ($36 +0 + 70)	*$106*
TOTAL	*$10,225*

The deductible amount of personal property taxes was $106. This amount is from the license and registration fees the couple paid for their cars.

(a) The deductible portion of the tax on vehicle registration consists of the amount of tax based on the vehicle's value, and not that portion based on the vehicle's weight. In Iowa, the registration fee is based on both value and weight. Iowa Code §321.109 computes the registration fee as follows:

(1) one percent of the value as fixed by the department, plus

(2) forty cents for each one hundred pounds or fraction thereof of weight of vehicle, as fixed by the department.

Walter's car is valued at $9,000 x 1% = $90
Walter's car's weight is 2,000 lbs. / 100 x .40 = <u>$ 8</u>
$98

Walter's truck is valued at $38,000 x 1% = $380
Walter's truck's weight is 6,100 lbs. / 100 x .40 = <u>$ 24</u>
$404

Stacey's car is valued at $7,000 x 1% = $70
Stacey's car's weight is 2,750 lbs. / 100 x .40 = <u>$11</u>
$81

Walter's Toyota total license fee of $98 is deductible as follows:

$90 (based on value) x 60% business use = $54 deductible on Schedule C, line 23 as "Taxes and Licenses."

$8 (based on weight) x 60% business use = $5 deductible on Schedule C, line 9 as "Car and Truck Expense."

$90 (based on value) x 40% personal use = $36 deductible on Schedule A, line 7 as "Personal Property Taxes."

$8 (based on weight) x 40% personal use = $3 non-deductible.

Walter's Ford Excursion total license fee of $404 is deductible as follows:

$380 (based on value) x 100% business use = $380 deductible on Schedule C, line 23 as "Taxes and Licenses."

$24 (based on weight) x 100% business use = $24 deductible on Schedule C, line 9 as "Car and Truck Expense."

Stacey's Honda total license fee of $81 is deductible as follows:

$70 (based on value) deductible on Schedule A, line 7 as "Personal Property Taxes."

$11 (based on weight) non-deductible.

Recap:
Schedule C, Line 23 deduction = $434 (54 + 380)
Schedule C, line 9 deduction = $29 (5 + 24)

Schedule A, line 7 deduction = $106 (36 + 0 + 70)

3. Lines 10-11 Home Mortgage Interest

You may generally deduct all the interest on debt secured by your main or second home when:

(a) The debt, regardless of amount, was incurred on or before October 13, 1987, and was not increased after that date.

(b) The debt is not more than $1,000,000 provided you used the proceeds to buy, build, or substantially improve your home.

(c) The debt was not used to buy, build, or substantially improve your home, but was equal to or less than $100,000 and does not exceed the equity in home.

The home can be a house, condo, mobile home, boat, or house trailer, but it does not include vacant land used for camping, Garrison, TC Memo 1994-200 (5/5/94). Vacant land may qualify, however, if contiguous to the principal residence, PLR 8940061, or when the residence is under construction, Temp. Reg. 1.163-10T(p)(5)(i) and Notice 88-74.

See IRS News Release IR 2002-114, which sets out some refinancing costs that are deductible and others that are not, such as recording, appraisal and inspection fees charged to the borrower.

The following interest expense was calculated with respect to the Burns:

Interest on Iowa City home	*$8,210*
2007 Investment Interest Expense	*$1,220*
TOTAL	*$9,430*

For AMT purposes you may deduct only the interest on the amount of the refinanced mortgage that does not exceed your outstanding mortgage before refinancing. See Code § 163(h).

4. Line 12 Points not Reported on Form 1098

Points on a home mortgage loan for the purchase or improvement of your principal residence are currently deductible if the points are an established business practice in the area, the points that are paid do not exceed the number of points generally charged in the area, and the points are paid with funds other than those obtained from the mortgage. Thus, points withheld from loan proceeds are not fully deductible in the year withheld. Code § 461(g)(2). Points or service charges that are charged as compensation for services that the lender performs, such as. appraisal or settlement fees, are not deductible as interest. FHA and VA loan points are not deductible as interest. See Rev. Rul. 67-297, 1967-2 C.B. 87; Rev. Rul. 69-188, 1969-1 C.B. 54; Wilkerson v. Comm'r, 70 T.C. 240 (1978), reversed on other grounds 655 F.2d 980 (9th Cir.1981). Points paid to refinance a home mortgage are not deductible in the year paid but must be deducted ratably over the period of the loan. Points paid on loans for other than a home mortgage are also to be deducted ratably over the terms of the loan. See Code §461(g). See also PLR 199905033.

In determining the deductibility of points paid in connection with the purchase of a principal residence, Rev. Proc. 94-27 notes the following requirements:

a. The points must be clearly designated on the settlement statement (i.e., "loan origination fees", "loan discount", or "discount points").

b. The points must be computed as a percentage of the amount borrowed.

c. The points charged must conform to the usual bank practice of the area, i.e., they may not be a substitute for other types of fees.

d. The points must be paid in connection with the acquisition of the principal residence and must be secured by the principal residence.

e. The points must be paid directly by the borrower, not from the proceeds of the loan this also includes points that are paid by the seller of the property.

Delinquency charges for late payments of a home mortgage cannot be deducted as interest. If the terms of a mortgage assess a delinquency fee for late payment of a mortgage, this fee cannot be characterized as interest. The IRS disallowed the characterization of the delinquent payment as interest and the Tax Court agrees. According to the Tax Court, the purpose of the delinquency charge is to: (1) compensate the mortgagee bank for its costs, (2) penalize the borrower for the purpose of discouraging late payments, and (3) compensate the mortgagee for the lost earnings on the late payments.

5. <u>Line 13</u> <u>Investment Interest</u>

Investment interest may be deducted up to the amount of net investment income. According to the Revenue Reconciliation Act of 1993, net investment income no longer includes net capital gain. "Net Capital Gain" is the excess of long-term capital gains over short term capital losses. This may significantly reduce the limitation on deductible investment interest. The amount of investment interest not deducted can be carried forward. See Code § 163(d). Investment income also does not include income from the rental of property where the taxpayer materially participated in the rental activity. <u>Ritter v. Comm'r</u>, T.C. Summary Opinion 2001-57 (2001).

The Revenue Reconciliation Act of 1993 excludes long-term capital gains from the calculation of the investment income limit on deducting investment interest. Congress felt that it would be inappropriate for a taxpayer who realizes long-term capital gain taxable at the lower rate to use that gain to deduct otherwise nondeductible investment interest against ordinary income.

Section 163(d) provides that the amount of investment interest for any taxable year that is not allowed as a deduction is treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year. Rev. Rul. 86-70 had held that a taxpayer may not carry over the disallowed investment interest to the extent that it exceeds the taxpayer's taxable income in the year the interest was paid or accrued. Since the Tax Court and four federal appellate courts have rejected that position, the IRS issued a new position in Rev. Rul. 95-16. Now it will allow the carryover of a taxpayer's disallowed investment interest to a succeeding taxable year. As a result, the deduction is not limited by the taxpayer's taxable income for the taxable year in which the interest is paid or accrued.

Walter and Stacey incurred $1,220 of investment interest in 2008.

6. <u>Lines 16-18</u> <u>Gifts to Charity</u>

Charitable contributions may only be claimed as an itemized deduction on Schedule A, Form 1040. Non-cash contributions can still be valued at their fair market value. See Code § 57(a)(6), see also <u>Herman v. U.S.</u>, 99-2 USTC paragraph 50, 899.

The AJCA-2004 sets forth rules relating to the charitable donation of automobiles effective for contributions after December 31, 2004. Specifically, vehicles (including boats and airplanes) with a claimed value of more than $500 must have contemporaneous substantiation of the value. Furthermore, if the donee sells the vehicle, without significant usage or improvements, the charitable deduction allowed the donor is limited to the sale proceeds.

Notice 2005-44 provides guidance to the new rules pertaining to the charitable donation of automobiles. Under AJCA-2004, the taxpayer may claim the fair market value of the automobile if the charity makes significant intervening use of the automobile or makes material improvements to the automobile. Notice 2005-44 explains that significant intervening use is when the charity uses the automobile to substantially further the charity's regularly conducted activities and the use must be significant. Notice 2005-44 also explains that material improvement includes major repair or improvement that improves the condition of the automobile in a manner that significantly increases the value.

Additionally, if the automobile is sold at a price significantly below fair market value to a needy individual in direct furtherance of the charity's charitable purpose, the taxpayer's charitable deduction is not limited to the sale price, as long as the taxpayer receives an acknowledgment from the charity within 30 days of the contribution.

The Burns have made both cash and non cash contributions. For the noncash contributions, Form 8283 must be prepared.

7. <u>Line 20</u> <u>Casualty or Theft Loss</u>

Nonbusiness casualty or theft losses may be deducted only to the extent that:

(a) the amount of each separate loss is more than $100, and
(b) the total amount of all losses for the tax year is more than 10% of AGI.

KETRA-2005 provides casualty or theft loss relief for the victims of Hurricane Katrina. To the extent a taxpayer's personal losses arose in the Hurricane Katrina disaster area after August 24, 2005, and were caused by Hurricane Katrina, the deduction is figured without regard to the $100 reduction per casualty or theft and the additional reduction of the aggregate net loss by 10% of adjusted gross income. This calculation is also used for AMT calculations.

8. Lines 21-26 Job Expenses & Other Miscellaneous Deductions

Most miscellaneous itemized deductions are subject to the 2% limitation. The amount deductible is limited to the total of these miscellaneous deductions that is more than 2% of AGI. Some of these expenses include: work clothes and uniforms, union dues and fees, safe deposit box rental, tax counsel and assistance, investment counsel fees, investment expenses, IRA fees, work-related supplies and tools, etc. See Code § 67.

Attorney fees. The deductibility of legal fees depends on the origin and character of the claim for which the expenses were incurred and whether the claim bears a sufficient nexus to the taxpayer's business. See Test v. Comm'r, 80 T.C.M. 776 (2000); Also, AJCA-2004 added IRC §62(a)(19) to include a new above-the-line deduction for attorney fees paid in specific types of claims.

The US Supreme Court settled a dispute among the federal circuits in 2005 by ruling that contingent attorney fees paid to a taxpayer's attorney as a part of a settlement or judgment are included in income and the deduction for those fees could be claimed on Schedule A as a miscellaneous itemized deduction, or as an above-the-line deduction if the cause of action fell within those types of cases listed in IRC §62(a)(19) (although not retroactively). Comm'r v. Banks, 125 S.Ct. 826 (2005).

Walter paid $3,333 of his $10,000 lawsuit settlement to his attorney. Because the lawsuit was not of the type enumerated in IRC §62(a)(19), such as unlawful discrimination, certain claims against the federal government, or a private cause of action under the Medicare Secondary Payer statute, Walter cannot deduct these fees above the line, but must claim them as a miscellaneous itemized deduction.

If an employee's business expenses are unreimbursed, the employee must use Form 2106 or 2106-EZ to figure the amount of unreimbursed business expenses that can be entered on Schedule A and claimed as a miscellaneous itemized deduction.

The Burns are required to complete Form 2106-EZ for Stacey's unreimbursed teaching expenses. Additionally, the Burns had $235 non-business expense for tax preparation fees and a $35 safe deposit box rental in 2008 that are deductible on Lines 22 and 23 respectively.

9. Line 28 Other Miscellaneous Deductions

On the example tax return, Walter and Stacey had gambling losses of $5,500 during 2008, these are included to the extent of their winnings ($5,000) on Line 28. (See Treas. Reg. §1.165-10 spouses' combined losses can offset combined winnings).

Gambling Losses. To provide adequate documentation for gambling losses, the taxpayer must keep an accurate record of all winnings and losses. See Rodriguez v. Comm'r, 81 T.C.M. 115 (2001). The record should contain the following:

(a) Date and type of specific wager or wagering activity;

(b) Name and location of the gambling establishment;

(c) Names of others present while gambling;

(d) Amounts won or lost.

More specifically, while playing slot machines, the taxpayer should keep a record of the machine number and all winnings by date and time the machine was played. While playing table games, the taxpayer should keep the number of the table at which they played, and casino credit card data indicating whether credit was issued in the pit or at a cashier's cage.

Unless the taxpayer is engaged in the trade or business of gambling, losses can only be utilized if the taxpayer itemizes. Torpie v. Comm'r, 79 T.C.M. 2064 (May 22, 2000).

10. Line 29 Limitation of Itemized Deductions

If the taxpayer's AGI exceeds $159,950 ($79,975 if married filing separately), IRC § 68 reduces itemized deductions on a sliding scale. The sliding scale takes 3% of the excess AGI over $159,950 (or $79,975) and could eliminate as much as 80% of your itemized deductions. (See Code §68(b)(1)).

The Burns' AGI is below the $159,950 threshold, and their itemized deductions will not be limited.

11. Line 29 Election to Itemize Deductions

If the taxpayer elects to itemize even though the itemized deductions are less than the standard deduction, the taxpayer must check the box on line 29.

SCHEDULE C - PROFIT OR LOSS FROM BUSINESS

The AJCA-2004 has modified the manner in which business start up costs and organizational expenditures are deducted. For costs or expenditures paid or incurred after October 22, 2004, a business can elect to expense up to $5,000 instead of amortizing those costs or expenditures. However, if the business has start-up costs or expenditures of more than $50,000, then the $5,000 allowable expense is reduced, (but not below zero) for every dollar these expenses exceed $50,000. The remainder of the start-up costs and organization expenditures, not allowed that first year, can be claimed as a deduction ratably over a 180-month period.

In 2004, the Tax Court reiterated that certain business expenses, deductible under IRC §274(d), such as travel, meals and lodging, gifts, entertainment and listed property requires strong record keeping. The required records include the amount, time and place, business purpose, and the business relationship between the taxpayer and the other person included. The Tax Court in the case of Moss v. Comm'r., TC Summary Opinion 2004-56, disallowed certain cell phone expense because the taxpayer did not produce such records. Similarly in Woods v. Comm'r., TC Memo 2004-114, the Tax Court disallowed all Schedule C expenses of the taxpayer that was either unable to unwilling to produce any substantiation of the expenses claimed.

Both Walter and Stacey have profits from their businesses and must each complete a Schedule C.

Rev. Proc. 2007-70 has updated the rules for which ordinary and necessary business expenses for lodging, meal and incidental expenses incurred while traveling away from home are deemed substantiated.

The substantiation of the expenses must include the amount, time and business purpose of the expense and must provide adequate records or sufficient evidence to corroborate the claimed amount. In Barton v. Comm'r, T.C. Memo 2005-97, the Tax Court determined that unreliable mileage records and meal and entertainment records that were created by the taxpayer more than three years later were not sufficient to substantiate the claimed expenses.

Stacey had four days of meal and incidental expenses on her trip to Newport, Kentucky in November. Thus, she is allowed the per diem rate of $45 per day as her meal and incidental expenses (limited to 50%) as well as the $80 per night for her hotel expense.

SCHEDULE E - SUPPLEMENTAL INCOME OR LOSS.

1. Vacation Homes.

The term "vacation home" is defined as a dwelling unit including a house, apartment, condominium, house trailer, boat, or similar property. It also includes any outbuildings, such as a garage, which relate to the use of the dwelling unit for living accommodations.

Specific limitations apply to the allowable business deductions that may be taken by a taxpayer who rents out a vacation home or other dwelling unit that he uses as his residence during the tax year. The purpose of the limitations is to curb the tax benefits that might otherwise be available to taxpayers who rent out homes in order to minimize their personal expenses rather than to make a profit from the rental. Limitations include minimal rental use and personal use.

The minimal rental use limitation provides that if the home is used by the taxpayer during the tax year as his residence and it is rented for less than 15 days during the taxable year, no deductions attributable to such rental are allowable and no income derived from such rental is includable in gross income. However, other allowable deductions in connection with the home, such as interest on a mortgage, state real estate taxes, and casualty losses, may still be deducted.

The personal use limitation provides that if the vacation home is rented for 15 or more days during the taxable year and it is used by the taxpayer for personal purposes for the greater of (a) more than 14 days or (b) more than 10% of the number of days during the year for which the home is rented, the deductions attributed to the rental activity are limited. In such case, the amount of the rental activity deductions may not exceed the amount by which the gross income derived from the rental activity exceeds the deductions otherwise allowable for the property (e.g., interest and taxes).

The order in which these deductions are to be taken in applying the limitation, however, is the same as that prescribed under Code § 183. This order is as follows: (1) taxes and interest allowable to rental use; (2) Operating expenses attributable to rental activities, except the expenses noted in (3) below; and (3) depreciation and other basis adjustment income.

If the taxpayer is engaged in repair and maintenance of the residence on a substantially full time basis for any day, such use will not constitute a personal use day. Twoheny, TC Memo. 1993-547 (11/22/93).

The personal use purposes stated above are those personal purposes by the following: (1) the taxpayer or any other person who owns an interest in the home, and relatives (spouses, brothers, sisters, ancestors, lineal descendants, and spouses of lineal descendants); (2) any individual who uses the home under a reciprocal arrangement, whether or not fair rental is charged; and (3) any other individual who uses the home during a day unless a fair rental is charged.

If a vacation home is owned by a partnership, estate, trust, or tax-option corporation, the number of days of personal use is determined by reference to the total number of days of personal use by the partners, beneficiaries, or stockholders, as the case may be.

The use of the dwelling unit by a relative will not be treated as "personal use" of the unit by the taxpayer if the unit is rented at a fair rental to such relative as that person's principal residence. The joint committee on "vacation homes" states that fair rental is to be determined by taking into account such factors as (1) comparable rentals in the area, and (2) whether substantial gifts were made by the taxpayer to the family member at or about the time of the lease or periodically during the year.

If the Burns' duplex in Iowa City had been used for personal use it would clearly fall under the definition of "vacation homes" set forth above. For example, let us assume that Walter and Stacey used the duplex for a total of 12 days, in 2008, and Walter's parents used it for a total of 18 days in 2008. Because Walter's parents are relatives of the Burns, their use of the duplex is added to the Burns use for the "personal use" test set forth above. If only Walter and Stacey's 12 days of use were counted for the "personal use" test, this total would be less than 15 days and all of their rental expenses would be deductible. However, their relative's use is added to their own use to total 30 days. Thus, "personal use" is greater than 14 days and they are subject to the deduction limitation. To compute the deduction limitation assume the gross rental income is $9,000. This is reduced by the interest and taxes attributable to the rental use of the property. The resulting figure is the ceiling on the amount of rental expenses allowed. There has been much dispute as to what ratio is properly used to compute the portion of interest and taxes attributable to the rental use of the property. Where this issue has been litigated, the Commissioner has contended that the number of days of rental use over the total number of days used (rental and personal) is the proper ratio for allocating all expenses. The taxpayer's position has been that interest and taxes should be treated differently than the rest of the rental expenses because interest and tax expenses are being incurred 365 days of the year while other rental expenses such as utilities and repairs are only incurred when used. In the case of Bolton v. Comm'r, 694 F.2nd 556 (9th Cir. 1982), the taxpayer's view was accepted and the ratio using the 365 days as the denominator, was ruled to be the proper one.

The significance of this decision is that less of the interest and taxes, which are deductible in any event, will be attributed to rental use. Thus, the ceiling will be higher for allowing operating expenses and depreciation.

The Burns have rental income to report on Schedule E, Page 1, as well as other pass through rental income/loss to report on Schedule E, Page 2.

Because the Burns have received a Schedule K-1 from PTP, Limited Partnership, which is a publicly traded partnership that has been assigned a tax shelter registration number, the Burns must report this number on Form 8271, and include the form with their 2008 tax return.

SCHEDULE H - HOUSEHOLD EMPLOYMENT TAXES

This tax, popularly referred to as the "Nanny tax" was expressly integrated into the Form 1040 in 1995. Also that year, a new schedule -- Schedule H -- was issued to report Social Security, Medicare, and Federal Unemployment taxes for household employees.

Household employers must include an employer identification number on their forms, including W-2s and the new Schedule H. (IRS Announcement 95-71). To apply for a EIN, household employers must complete and file a Form SS-4.

IRS Notice 95-18 further addresses the issues of this tax by a series of questions and answers. It clarifies that household employers no longer are required to file quarterly 942 forms, but rather include the information on the Form 1040 Schedule H.

Because the Burns have hired Esther to work in their home and have paid her more than $1,600 in 2008, they must file the attached Schedule H with their 2008 return.

Additionally, the Burns will prepare a W-2 for Esther:

SCHEDULE SE - SELF-EMPLOYMENT TAX

The self-employment tax is imposed on self-employed persons for the purpose of providing social security benefits. It taxes self-employment income which is defined as "net earnings from self-employment". If the net earnings from self-employment is less than $400, there is no self-employment tax due. In 2008, the maximum amount of taxable self-employment income for FICA purposes is $102,000 and for Medicare purposes is unlimited. The total self-employment income is multiplied by 92.35%, and the resulting figure is taxed at the self-employment tax rate.

The tax rate for self-employment is 15.3% which consists of 12.4% for FICA and 2.9% for Medicare.

Walter’s business had net earnings from self-employment as shown on Schedule C. Additionally, Stacey's business had net earnings from self-employment as shown on Schedule C. Therefore, both must file a Form SE and pay self employment tax.

Clients may ask how they can avoid paying self-employment tax on their earnings from a sole proprietorship. One seemingly easy solution is to incorporate their business and make an S-election. However, this will not shelter the taxpayer from employment taxes and may lead them to penalties and interest if attempted. In Charlotte's Office Boutique, Inc. v. Comm'r., 121 T.C. No. 6 (August 4, 2003), the taxpayer incorporated her business, but did not convey the customer lists to the new company. The corporation then paid the taxpayer royalties for the use of the lists. The Tax Court ruled that the royalty payments were wages, and the corporation was also liable for unreported employment tax and penalties for failing to file Form 941 and failing to make deposits.

In 2005, the Ninth Circuit Court of Appeals reversed and remanded a Tax Court decision that had ruled the salary of the president of a closely held corporation was too high (salary claimed was $861,000, $818,000 and $600,000 for the years in question). The Tax Court determined that the president's role in the company was equivalent to that of a typical outside board chair and reduced the allowable salary to $100,000 per year. However, the Ninth Circuit disagreed and ruled that the president's revised salary was less than subordinate employees, including that of her sons, and her salary should be based on her role as the president of the company. E. J. Harrison & Sons, Inc. v. Comm'r, 138 Fed. Appx. 994 (9th Cir. 2005).

FORM 2106-EZ - EMPLOYEE BUSINESS EXPENSES

If an employee's business expenses are unreimbursed, the employee must use Form 2106 or 2106-EZ to figure the amount of unreimbursed business expenses that can be entered on Schedule A and claimed as a miscellaneous itemized deduction.

Expenses are deemed paid or incurred under a reimbursement or expense allowance arrangement that requires the employee to substantiate the expenses to the employer, and requires the employee to return any amount in excess of the substantiated expenses. The employee covered by a reimbursement arrangement is entitled to an above-the-line deduction for expenses covered by the arrangement. The employee offsets any amounts received under the reimbursement arrangement against such expenses, rather than including the reimbursement in gross income and claiming the deduction from gross income. If the employee seeks to deduct expenses in excess of the reimbursed amounts, these excess expenses are computed on Form 2106 where the employee offsets expenses to the extent of the amounts paid under the arrangement and are included as miscellaneous itemized deductions subject to the 2% limitation.

In Whalen v. Comm'r, T.C. Summ. Op. 2005-45, the Tax Court disallowed a portion of the taxpayer's claimed unreimbursed employee business travel expenses. Although the employer had a travel reimbursement policy for ordinary and necessary business expenses, the taxpayer did not seek reimbursement for much of his expenses. The Tax Court stated: "When a taxpayer has the right to obtain reimbursement for his employee business expenses from his employer but fails to seek reimbursement, the taxpayer cannot deduct the expenses because it is not necessary for the taxpayer to remain unreimbursed."

The per diem rate for meals and lodging have been modified once again by Rev. Proc. 2008-59, reflecting rate changes for expenses after October 1, 2008. The new Rev. Proc. also contains an updated list of the high cost localities.

Pursuant to Rev. Proc. 97-58 and revised by T.D. 8864, 2000-7 IRB 614, the IRS allows the use of standard mileage deduction for automobiles which are leased as well as those which are owned.

The business standard mileage rate for 2008 is $0.505 per mile (See Rev. Proc. 2007-70) through July 1, 2008 The business standard mileage rate increases to $0.585 per mile after July 1, 2008 (See 2008-63).

On the example tax return, Stacey had the following unreimbursed employee expenses:

Standard Mileage:
971 miles @ $0.505 = Total 490

Stacey had Instruction Materials $410; Supplies $180; Student Project Supplies $670; and Prizes $190; totaling $1,450 of unreimbursed employee expenses. Stacey's unreimbursed employee expenses on Form 2106-EZ total $1,882. ($490 + $1,450 = $1,882).

FORM 2441 - CHILD AND DEPENDENT CARE EXPENSES

Child and dependent care expenses are those paid for the care of a taxpayer's child or other qualified person which allows the taxpayer to work or look for work.

A qualifying person is: (1) a child under 13 years old claimed as a dependent; (2) disabled spouse; (3) a disabled person whom the taxpayer can claim as a dependent (or could claim as a dependent except that the person had more than $3,300 in gross income during the year or filed a joint return); or (4) a disabled person whom the taxpayer could claim as a dependent except that the taxpayer (or the taxpayer's spouse if filing a joint return), could be claimed as a dependent on someone else's 2008 return.

The qualifying person must have shared the home with the taxpayer during 2008. There are exceptions for children of divorced or separated parents which allow a parent who does not claim the child as a dependent to nonetheless claim the child and dependent care expenses credit.

Qualified expenses are amounts paid for household services and care of the qualifying person while the taxpayer worked or looked for work. If married filing joint, both spouses must have worked during the time in which the dependent care expenses were incurred. However, if a spouse is a full-time student or disabled, they may be treated as if they worked during that period of enrollment or disability.

If a taxpayer received dependent care benefits from their employer either directly to the care provider or the taxpayer, or the employer provided a day care facility, the taxpayer must file Form 2441 to determine if any of these benefits must be included on Line 7 of Form 1040.

The credit is based on a number of qualifying persons, the amount of qualifying expenses paid, and the income earned by the parent(s).

The Burns paid a total of $5,210 in qualified expenses for the care of George and Grace. Stacey received dependent care benefits through her employer's cafeteria plan of $4,000.

FORM 4562 - DEPRECIATION & AMORTIZATION

RECOVERY CLASSES & RATES:

Recovery Period	Examples	Rate
3 years	Hogs, racehorses	200% D.B.
5 years	Cars, * general purpose trucks, beef & dairy cattle, sheep, goats, computers, solar & wind energy	200% D.B.
7 years	Equipment & Machinery, single-purpose agricultural structures, grain bins, fences, office furniture, breeding horses	200% D.B.
10 years	Assets used to manufacture grain, sugar products & vegetable oils, railroad tank cares, manufactured homes & coal utilization property	200% D.B.
15 years	Depreciable land improvements not otherwise listed	150% D.B.
20 years	Farm buildings	150% D.B.
27.5 years	Residential rental property	Strt. line
39 years	Non-residential real property	Strt. line

*The depreciation deduction for a passenger automobile placed in service in 2008 may not exceed $2,960 for the first year (Rev. Proc. 2007-30). The depreciation deduction for trucks and vans placed in service in 2008 may not exceed $3,160 for the first year.

STRAIGHT LINE DEPRECIATION LIVES:

Residential & non-residential real estate - 40 years.
Class life property over ADR midpoint:

- 5 years - Light trucks.
- 7 years - Breeding stock & dairy cattle.
- 10 years - Machinery, bins, fences.
- 15 years - Single-purpose structures.
- 20 years - Drainage facilities.
- 25 years - Farm buildings.

ONE-HALF YEAR CONVENTION: For property in the 3, 5, 7, or 10 year class, the 200% declining balance method over these years and the half-year convention are used. For property in the 15 or 20-year class, the 150% declining balance method over these years is used with the half-year convention.

Depreciation is allowed for ½ year the first year and in the year of disposition. However, if the taxpayer purchases more than 40% of the new equipment in the last quarter, the property must be depreciated by quarter, using depreciation from the midpoint of each quarter.

The 30% and 50% additional first year depreciation allowance has come to an end.

§179 Expense Election: In 2008, the §179 deduction is after inflation adjustment $112,000. Also, the "phase out" of §179, based on the total cost of qualifying property placed into service in 2008 is increased to $800,000.

§179 and Amended Returns: In Treas. Decision 9146, the IRS has issued regulations that will now allow a taxpayer to elect or revoke an election to use §179 on an amended return. This can give a taxpayer significant flexibility as a tax planning and possibly even an audit technique.

No More Full §179 for SUV's: Effective for sport utility vehicles (SUV's) purchased after October 22, 2004, the AJCA-2004 reduces the available §179 deduction to $25,000. SUV's are defined for purpose of §179 as any 4-wheeled vehicle which is primarily designed or which can be used to carry passengers over public streets, roadways, or highways (except any vehicle operated exclusively on a rail or rails), which is not subject to §280F, and is rated at not more than 14,000 pounds gross vehicle weight.

Also specifically excluded from this definition of an SUV is any vehicle that:

(1) is designed to have a seating capacity of more than 9 persons behind the driver's seat (for example, the 2005 Ford E-350 SD XLT extended full size van with 15-person seating falls into this category).

(2) is equipped with a cargo area of at least 6 feet in interior length which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment, (for example, the 2005 Ford F-150 4 x 4 Supercrew Pickup with its 6-foot box falls into this category) or

(3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edges of windshield.

Stacey has purchased new business property in 2008.

<u>FORM 4797 - SALE OF BUSINESS PROPERTY</u>

Form 4797 is used to report:

1. The sale or exchange of (a) property used in your trade or business; (2) depreciable and amortizable property; (c) oil, gas, geothermal, or other mineral properties, and (d) § 126 property.

2. The involuntary conversion (from other than casualty or theft) of property used in your trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit.

3. The disposition of noncapital assets (other than inventory or property held primarily for sale to customers in the ordinary course of your trade or business).

4. The disposition of capital assets not reported on Schedule D.
5. The recapture of § 179 expense deductions for partners and S corporation shareholders from property dispositions by partnerships and S corporation.

6. The computation of recapture amounts under § 179 and § 280F(b)(2), when the business use of § 179 or listed property drops to 50% or less.

The condemnation of property, or the forced sale under the threat or imminence of condemnation is considered an involuntary conversion under § 1033(a)(2)(E)(ii). The amount realized from a condemnation equals the compensation or award received less the sum of the adjusted basis of the property plus any costs associated with the sale or the condemnation proceedings. The realized gain can however be deferred if the condemned property is replaced within the allowed time period and by the allowed type of property.

The time period within which condemned property must be replaced is the period beginning with the date of the disposition of the condemned property, or the earliest date of the threat or imminence of requisition or condemnation of the condemned property, whichever is the earlier, and ending:

(1) two years after the close of the first taxable year in which any part of the gain upon the conversion is realized, (2) three years after the close of the first taxable year in which any part of the gain upon the condemnation of real property held for productive use or for rental or investment is realized, (3) four years after the close of the first taxable year in which any part of the gain upon the conversion is realized on a principal residence converted due to presidentially declared disasters, or (4) at the close of such later date as the IRS may designate on application by the taxpayer.

The replacement property must be similar or related in service or use to the property it is replacing. However, the replacement of condemned real estate held for productive business use or for rental or investment need only be of like kind.

FORM 8283 - NONCASH CHARITABLE CONTRIBUTION

Tax planning point:

Consider giving away appreciated property, such as stocks or mutual fund shares, rather than cash. You get the same deduction, the charity gets the same amount, but the government gets less. Assuming you have owned the asset more than a year, you get to deduct the current value of the gift, but you do not have to pay tax on the appreciation that built up while you owned it.

Giving away appreciated assets can make sense even if you were not planning to get rid of the securities. Say you are planning a $5,000 gift to your church's building fund. Instead of cash, you give $5,000 worth of stock that, if you sold it, would produce a $2,500 gain. You get a $5,000 deduction (saving you $1,250 in the 25% bracket) and avoid the $375 (in the 15% capital gains rate bracket) tax on the gain. You can then use your $5,000 cash to buy back the stock. Your basis will be $5,000 and only future appreciation will be taxable.

The Revenue Reconciliation Act of 1993 permanently eliminated the appreciation as a preference item for the alternative minimum tax calculation. Also, in PLR 9321063 (March 2, 1993), the IRS agreed that a taxpayer with positive regular tax AGI but a much larger AMT AGI was entitled to a larger AMT charitable deduction using percentage limits based upon AMT AGI rather than regular AGI.

Quid Pro Quo Contributions. Charitable organizations will be required to inform donors in writing that quid prop quo contributions in excess of $75 made on or after 1/1/94 are only deductible to the extent that the contributions are in excess of the goods or services received from the organization. The organization is required to give a good faith estimate of the goods or services furnished to the donor by the organization. Failure to comply with such disclosure is subject to penalties. (See § 6714)

Capital gain property donated to a “50% charitable entity” is limited to 30% of the taxpayer’s AGI, while capital gain property donated to a “30% charitable entity” is limited to 20% of the taxpayer’s AGI. Examples of 30% charitable entities are Veterans’ Organizations, Fraternal Orders, Cemetery Companies and certain Private Nonoperating Foundations.

The Burns had more than $500 of noncash charitable contributions in 2008 and must file Form 8283.

FORM 8582 - PASSIVE ACTIVITY LOSS LIMITATIONS

The passive activity loss is the amount by which the total losses from all passive activities for the tax year exceed the total income from all passive activities for the tax year.

Passive activity losses not allowed in the tax year may be carried forward to the next year. Any passive activity losses that have accumulated because of the annual limit will be allowed in the tax year in which the taxpayer disposes of the interest in the activity. The taxpayer must dispose of the entire interest in the activity in a transaction in which all realized gain or loss is recognized to an unrelated taxpayer.

No passive activity losses will be allowed to offset non-passive income. A special $25,000 offset of non-passive income applies to individuals who "actively participate" in their rental real estate activities during the tax year. However, if a taxpayer rents property to a business in which the taxpayer materially participates, Treas. Reg. §1.469-2(f)(6) recharacterizes the rental income as non-passive. See Krukowski v. Comm'r, 114 T.C. No. 25 (May 22, 2000) and Fransen v. U.S., 99-2 USTC Paragraph 50,882.

The "active participation" standard is satisfied so long as the taxpayer participates in a significant and bona fide sense, such as by making management decisions or by arranging for others to provide services such as repairs. Relevant management decisions include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

The offset allows qualifying taxpayers to use up to $25,000 of otherwise unallowable losses from rental real estate activities to offset other income (non-passive income). The special $25,000 offset for rental real estate Activities is phased out for taxpayers with AGIs between $100,000 and $150,000.

The passive loss rules are contained in Code § 469. The $25,000 offset for rental real estate activities is in § 469(i). Also useful is the Passive Activity Loss Audit Guide released by the IRS on 4/25/94.

Beginning in 1994, losses from a rental real estate activity meeting the requirements of Code § 469(c)(7) are no longer considered per se passive activities. An individual will satisfy the eligibility requirements when:

1. More than 50% of the individual's personal services during the tax year is performed in real property trades or businesses in which the individual materially participates, and

2. The individual performs more than 750 hours of service in the real property trades or businesses in which the individual materially participates. In the case of a joint return, the eligibility requirements are met only if either spouse separately satisfies all but the material participation requirements. In other words, the spouses cannot combine their respective personal services and hours of service to meet the requirements.

FORM 8829 - HOME OFFICE EXPENSE

A home office deduction is allowed for employees, self-employed individuals and investors for certain expenses for the use of the home as an office. The percentage of space within the residence that is used exclusively for the office, is the percentage by which many items, such as mortgage interest, real estate taxes, capital improvements and even depreciation may be taken as a deduction from the income of a trade or business operated from within the home. In addition, that same percentage of the utilities, insurance and other normally nondeductible household expenses are transformed into deductible expenses on the Form 8829.

The Small Business Jobs Protection Act of 1996 permits the deduction, for tax years beginning after December 31, 1995, for “home office” expenses relating to a storage unit within the taxpayer’s home that is regularly used for inventory or product samples of the taxpayer’s trade or business. The taxpayer’s trade or business must be the retail or wholesale sales of those products, as long as the home is the sole location of the trade or business.

Additionally, with the passage of the Taxpayer’s Relief Act of 1997, a taxpayer can now treat expenses related to a home office as deductible expenses if:

1. the office is used by the taxpayer to conduct administrative or management activities of a trade or business, and

2. there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

This change in the law overturns the infamous Soliman case law. This change is effective for tax years beginning after December 31, 1998.

FORM 8824 - LIKE-KIND EXCHANGES

IRS §1031 allows a taxpayer to defer the recognition of gain on the exchange of property held for productive use in a trade or business or held for investment if the property is exchanged solely for property of a like-kind that is to be used in a trade or business or for investment.

The basis of the acquired property is the same as the basis of the exchanged property, less any money received, plus any gain recognized.

Section 1031 also allows a deferred exchange as long as the property to be received is identified within 45 days of the transfer of the relinquished property AND is received by the earlier of 180 days after the transfer of the relinquished property or the due date (including extensions) of the tax return for the year of the transfer.

The use of a qualified intermediary is allowed to facilitate a like-kind exchange among several parties. Additionally, PLR 200236026 now allows the use of web-based qualified intermediaries.

However, §1031(f) sets out rules for transactions involving related parties. Specifically, if either related party sells or disposes of the property involved in the exchange within two years of the date of the last transfer, either directly or indirectly (such as through an intermediary), the non-recognition principles of §1031 are not allowed unless:

(a) the disposition was after the death of either of the related parties;
(b) the disposition was an involuntary conversion, and the threat of conversion occurred after the exchange;
(c) you can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as its principal purpose.

In Rev. Rul. 2002-83, the IRS made it clear that the transfer of property through a qualified intermediary does not remove the transaction from the related party rules of §1031(f).

In Teruya Bros. Ltd. v. Comm'r, 124 T.C. No. 4 the Tax Court ruled that the structure of the like-kind exchange transactions had been designed to avoid the application of the related party like-kind exchange rules. The taxpayer, Teruya, exchanged two Hawaiian properties for properties formerly owned by another entity, Times, (which the taxpayer owned 62% of its stock). The qualified intermediary sold the two properties to unrelated parties and Times received the proceeds plus additional cash from Teruya. The Court ruled this was the equivalent to direct exchanges of property between Teruya and Times followed by Times' sale of the property to unrelated parties, regardless of the fact that there was a qualified intermediary included in the transactions.

Rev. Proc. 2005-14 provides guidance on the tax consequences of exchanging property that satisfies both the requirements for the exclusion of gain from the sale of a principal residence, IRC §121; and the non-recognition of gain on the exchange of like-kind properties, IRC §1031. For example, when the taxpayer lives in her personal residence for three years, then converts it to a rental property for two years, then exchanges the property for a new principal residence.

The Rev. Proc. explains that IRC §121 is applied first, followed by IRC §1031 for gain attributable to depreciation. In applying the IRC §1031 provisions, only the boot received for property used in the trade or business is taken into account to the extent the boot exceeds the gain excluded under IRC §121. The basis of the replacement property includes any gain excluded by IRC §121.

For example, assume Taxpayer buys a house for $210,000 that he uses as his principal residence from 1999 to 2003. From 2003 until 2005, he rents the house to tenants and claims depreciation deductions of $20,000. In 2005, he exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that he intends to rent to tenants. The taxpayer realizes gain of $280,000 on the exchange.

The taxpayer's exchange of a principal residence that he rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both IRC §§121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because the taxpayer owns and uses the house as his principal residence for at least 2 years during the 5-year period prior to the exchange, he may exclude gain under §121. Because the house is investment property at the time of the exchange, he may defer gain under §1031.

The taxpayer first applies §121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of §1031. The taxpayer may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under §1031. Although the taxpayer receives $10,000 of cash (boot) in the exchange, he is not required to recognize gain because the boot is taken into account for purposes of §1031(b) only to the extent the boot exceeds the amount of excluded gain.

To recap:

Amount realized		$470,000
Less:	Adjusted basis	$190,000
Realized gain		$280,000
Less:	Gain excluded under §121	$250,000
	Gain to be deferred	$ 30,000
Recognized Gain		$ 0

The taxpayer's basis in the replacement property is $430,000, which is equal to the basis of the relinquished property at the time of the exchange ($190,000) increased by the gain excluded under §121 ($250,000), and reduced by the cash he receives ($10,000).

FORM 8889 – HEALTH SAVINGS ACCOUNT (HSAs)

The Medicare Prescription Drug Improvement and Modernization Act of 2003 created the new

Health Savings Account (HSA), which allows taxpayers to save for qualified medical and retiree health expenses on a tax-free basis. Individuals under the age of 65 can contribute to an HSA if they have a qualified health plan.

An individual's qualified health plan must have a minimum deductible of $1,100 with a $5,600 cap on out-of-pocket expenses. A family qualified health plan must have a minimum deductible of $2,200 with a $11,200 cap on out-of-pocket expenses (these amounts are indexed annually for inflation). However, preventive care services, as well as coverage for accidents, disability, dental care, vision care, and long-term care are not subject to the deductible.

The taxpayer may contribute up to 100% of the health plan deductible (up to a maximum of $2,900 for an individual HSA and $5800 for a family HSA as indexed annually for inflation). Additionally, each individual age 55 - 65 may make additional "catch-up" contributions of up to $900 in 2008, increasing to $1,000 annually in 2009. (See IRC §223(b)(3))

Contributions may be made by individuals, family members and employers and are tax deductible, even if the account beneficiary does not itemize their deductions on Schedule A. The contributions are an above the line deduction on Form 1040. Employer contributions are made on a pre-tax basis and are not taxable to the employee. Employers are also allowed to offer HSAs through their cafeteria plan.

The earnings on the HSA account accrue tax-free. Additionally, HSA distributions are tax-free if they are used to pay for qualified medical expenses. Qualified medical expenses include prescription drugs, qualified long-term care services and long-term care insurance, COBRA coverage, Medicare expenses (but not Medigap), and retiree health expenses for individuals age 65 and older.

Distributions made for any other purpose are subject to income tax and a 10% penalty. The 10% penalty is waived if the taxpayer is age 65 or older or in the event of the death or disability of the taxpayer. Upon death, the HSA can be transferred to the deceased taxpayer's spouse tax-free.

Rev. Rul. 2005-25 confirms that where the taxpayer's spouse has a non-high deductible health plan with family coverage, but does not cover the taxpayer, the taxpayer can contribute to his own HSA. That taxpayer's maximum HSA contribution is based on whether he has an individual or family coverage high deductible health plan.

IRS Notice 2005-8 provides guidance for partnerships, partners, S-corporation and 2% shareholders with HSAs. The Notice confirms that partnerships can contribute to a partner's HSA and an S-corporation can likewise contribute to a 2% shareholder/employee's HSA. For a partnership, the contributions are not deductible by the partnership but (i) are treated as a distribution of money on Schedule K-1, (ii) are not included in the partner's gross income from the partnership because the distribution does not affect the partner's share of partnership income or loss, and (iii) would be deductible as an above-the-line deduction by the partner. However, for contributions for a partner that are treated as guaranteed payments, or for contributions for a 2% shareholder/employee of an S-corporation, the HSA contributions (i) are deductible by the entity, (ii) are includible in the partner's or 2% shareholder/ employee's gross income and (iii) would be deductible as an above-the-line deduction by the partner or 2% shareholder/employee.

The Burns had a high deductible health plan in 2008 and contributed $2,100 to their HSA. They received reimbursements of $1,854 from the HSA for qualified medical expenses.

FORM 8903 - DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

AJCA-2004 created the Domestic Production Activities Deduction ("DPAD"), calculated on new IRS Form 8903. This deduction is equal to 6% for 2007 – 2009 and 9% thereafter, of the lesser of:

(1) the Qualified Production Activities Income ("QPAI") of the taxpayer; or
(2) taxable income (or adjusted gross income for an individual), determined without regard to the DPAD.

The DPAD is further limited to 50% of the W-2 wages paid by the taxpayer in the calendar year that ends in the tax year. IRS Notice 2005-14 sets out three options to determine the amount of W-2 wages for the purpose of this limitation:

1. Unmodified Box Method – this is the lesser of (1) the total entries in Box 1 of all Forms W-2 filed with the Social Security Administration or (2) the total entries in Box 5 of all Forms W-2 filed with the Social Security Administration.

2. Modified Box 1 Method – this is calculated by subtracting from the total entries in Box 1 of all Forms W-2 (1) amounts included in Box 1 that are not wages under IRC §3401(a) and (2) items treated as wages under IRC §3402(o), and adding to that any elective deferrals that are reported in Box 12 of Forms W-2 with Codes D, E, F, G and S.

3. Tracking Wages Method – this is calculated by tracking the actual amounts of wages subject to federal income tax withholding, subtracting supplemental unemployment compensation benefits, and adding elective deferrals that are reported in Box 12 of Forms W-2 with Codes D, E, F, G and S.

QPAI is calculated by subtracting the cost of goods sold, other deductions, expenses and losses that are directly allocable to the Domestic Production Gross Receipts ("DPGR") as well as a ratable portion of deductions, expenses and losses that are not directly allocable from the total DPGR. Under IRS Notice 2005-14, the taxpayer is required to determine the QPAI on an item-by-item basis. If the taxpayer is engaged only in the manufacture of qualified production property, and has no other sources of income, QPAI should be the same as taxable income. Notice 2005-14 further provides a safe harbor for determining DPGR that allows a taxpayer to treat all receipts as DPGR if less than 5% of the taxpayer's gross receipts are non-DPGR.

DPGR consists of gross receipts of the taxpayer which are derived from

(i) any lease, rental, license, sale, exchange, or other disposition of:

(I) qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States,

(II) any qualified film produced by the taxpayer, or

(III) electricity, natural gas, or potable water produced by the taxpayer in the United States,

(ii) construction performed in the United States, or

(iii) engineering or architectural services performed in the United States for construction projects in the United States.

The definition of DPGR specifically excludes gross receipts of the taxpayer which are derived from:

(i) the sale of food and beverages prepared by the taxpayer at a retail establishment, and

(ii) the transmission or distribution of electricity, natural gas, or potable water.

Stacey's candle manufacturing business had gross receipts of $10,560, costs of goods sold of $4,806 and other allocable expenses of $4,824. Her QPAI of $930 is calculated on Form 8903. This amount is multiplied by 3% to reach the tentative DPAD of $56. This amount is then limited to 50% of the amount of W-2 wages paid to her employee. Stacey uses the Unmodified Box Method, and determines that the W-2 wage limitation is $525 (50% of $1,050). Therefore, Stacey is able to deduct the entire $56 as her 2008 Domestic Production Activities Deduction as an above-the-line deduction on line 35 of Form 1040.

Obviously, a deduction of only 6% of the taxpayer's QPAI, which in Stacey's case would amount to a federal tax savings of approximately $14 ($56 deduction x 25% marginal tax rate) may not justify the time and cost that can be involved with tracking and calculating QPAI. However, in other cases, where the taxpayer has a significant amount of domestic production activities, the deduction and resulting tax savings could be quite significant and well worth the taxpayer's and the tax practitioner's time and expense.

V. OTHER COMMENTARY

PRIVATE DELIVERY SERVICES

Under §7502(f), Congress authorized the IRS to designate certain Private Delivery Services. (“PDSs”) Effective January 1, 2005, the list of designated PDSs is as follows:

1. DHL Express (DHL): DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Service;

2. Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First; and

3. United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

<u>Only these specific delivery types</u> by these specific Private Delivery Services will qualify for the “timely mailing as timely filing/paying” rule. (See Notice 2004-83).

FORM W-7P PREPARER TAX IDENTIFICATION NUMBER

Tax preparers can apply for and obtain a Preparer Tax Identification Number ("PTIN"). This application is submitted on Form W-7P. The PTIN is used in place of the preparer's Social Security number, but not in place of an EIN. If a preparer received a PTIN in prior years it remains effective thereafter.

This is an elective procedure. Tax preparers can continue to include their Social Security numbers on the tax returns they prepare if they so choose. However, with the increase in the problems associated with "stolen identities", the acquisition and use of a PTIN is a good idea. The Form W-7P can be obtained through the IRS web site at "www.irs.gov". The form can then be faxed to the IRS and a notification, by mail, of your newly assigned PTIN will be sent within six weeks of submission.

VI. EDUCATION TAX INCENTIVES

COVERDELL EDUCATION SAVINGS ACCOUNTS

Beginning in 1998, taxpayers were given an opportunity to contribute up to $500 per year into an Education IRA, renamed Coverdell Education Savings Accounts ("ESA") by the EGTRRA 2001, for a child under the age of 18. For 2008, anyone is allowed to make the contribution as long as the total amount contributed to any one child's ESA does not exceed $2,000. However, the amount that a person can contribute is ratably reduced for modified AGI's between $190,000 and $220,000 (married filing joint) and $95,000 and $110,000 (for all other filers). The instructions to Form 8606 contain a worksheet to assist in calculating the amount that an individual can contribute.

All earnings on the contributions accumulate tax free, and no tax is due on the distributions from the ESA as long as the distributions are for qualified higher education expenses.

In the event the child does not attend a post-secondary institution, the amounts in the ESA can be rolled over to another family member's ESA to be used for their qualified higher education expenses. Alternatively, the child can withdraw the amount in the ESA and pay income tax plus a 10% excise tax on the income earned thereon.

There is no tax deduction for the contribution to an ESA.

Beginning in 2002, EGTRRA 2001 repealed the 6% excise tax that was imposed on amounts contributed to an ESA on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified state tuition plan (College Savings Iowa plan) on behalf of the same beneficiary.

"COLLEGE SAVINGS IOWA" PROGRAM
(AN EXAMPLE OF A § 529 PLAN)

Walter and Stacey contributed $2,500 to each of their children's College Savings Iowa accounts in 2008. While there is no federal tax consequence to these contributions, the following contains excerpts from this program's web page at "http://collegesavingsiowa.uii.upromise.com".

College Savings Iowa is administered by the Treasurer of State and is designed to encourage adults to save for the future educational expenses of young people.

Contributions are tax deductible at the state level and the earnings are exempt from state taxes altogether. Withdrawals for higher education are also exempt from federal income tax.

Plan benefits can be used at all accredited public and private institutions of higher learning. Citizens can even use it for schools located out of state. The participant or beneficiary is not required to be an Iowa resident.

Each adult (the “Participant”) may save a minimum of $25 per year per child (the “Beneficiary”) up to a maximum of $2,685 per year per child in 2008. The maximum amount is adjusted annually for inflation.

Parents can save for children. Grandparents can save for grandchildren. Aunts and uncles can save for nieces and nephews. Stepparents can save for stepchildren. In fact, friends can save for friends; there is no relationship required.

More than one Participant can save on behalf of a Beneficiary. Mom and Dad, as well as other adults, can each invest up to the maximum per child per year.

College Savings Iowa, pursuant to IRS rules, establishes an account balance limit (based upon five years of undergraduate enrollment at the highest cost eligible institution) which is currently $320,000. Once the aggregate account balance for all accounts held on behalf of a Beneficiary exceed the applicable account balance limit, future contribution to any of the accounts are barred.

A single Participant may save on behalf of more than one Beneficiary up to the annual maximum for each Beneficiary.

All of a Participant's contributions are tax deductible for state income tax purposes and the earnings are exempt from state taxation altogether so long as the funds are spent for the "qualified higher education expenses" of a Beneficiary. The College Savings Iowa account statements for January 2008 will include or verify the amount you may deduct on line 24 of the 2008 IA 1040 - Iowa Individual Income Tax Long Form. The form will refer you to the instructions.

A Participant must: 1) be a resident of any state, 2) be age 18 or older, 3) have a valid social security number, 4) have a desire to save for the future educational expenses of a young person, and 5) complete a Participation Agreement.

A Beneficiary must: 1) be a resident of any state, 2) be under age 18 on the date a participation agreement is submitted, and 3) have a valid social security number. A Participant must submit with a Participation Agreement the Beneficiary's valid social security number and proof that the Beneficiary is under age 18.

If the original Beneficiary doesn't go to college, a Participant may substitute one Beneficiary for another as long as: 1) the original Beneficiary has not been admitted to at an eligible institution, 2) the substitute Beneficiary is eligible, and 3) the substitute Beneficiary is a member of the original Beneficiary's family.

If another Beneficiary does not exist, a refund will be made to the Participant. However, if a refund is made to the Participant for any reason other than the Beneficiary's death, disability or receipt of a scholarship, the Participant will be penalized 10% on the earnings (after December 31, 2001, this is called a 10% federal tax).

The following is an overview of the education related tax incentives currently available to taxpayers.

	Tax Benefit	**Available for**	**Phase Out Limits**	**Comments**
Hope Credit	Up to $1,800 per student tax credit for tuition and fees	First and second year of college only	$48,000 - $58,000 (single); $96,000 – $116,000 (married filing joint)	Must be at least half-time in degree program
Lifetime Learning Credit	Up to $2,000 per family tax credit for tuition and fees	College, graduate school and courses that improve job skills	$48,000 - $58,000 (single); $96,000 – $116,000 (married filing joint)	
Student loan interest	Above-the-line deduction up to $2,500	College, graduate school	$55,000 - $70,000 (single); $115,000 – $145,000 (married filing joint)	Must have been half-time or more in degree program
Tuition and fees	Up to $4,000 Deduction per family	College, graduate school	$65,000 - $80,000 (single); $130,000 – $160,000 (married filing jointly)	
Coverdell Education Savings Account	Tax-free earnings on investments spent on education	K-12 and college graduate schools	$95,000 - $110,000 (single); $190,000 – $220,000 (married filing jointly)	Allowable expenses for K-12 include tuition, fees, tutoring, uniforms, transportation, computers
State-sponsored tuition plan (529 plan)	Tax-free earnings on investments spent on education	College, graduate school	No phase-out limits	Allowable expenses include tuition, fees, books supplies, room and board

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