Individuals—Special Tax Situations
Quickfinder® Handbook
(2012 Tax Year)

Updates for the American Taxpayer Relief Act of 2012

**Instructions:** This packet contains “marked up” changes to the pages in the *Individuals—Special Tax Situations Quickfinder® Handbook* that were affected by the American Taxpayer Relief Act of 2012, which was enacted after the handbook was published. To update your handbook, you can make the same changes in your handbook or print the revised page and paste over the original page.
Non-U.S. Citizen Tax Filing Summary

<table>
<thead>
<tr>
<th>Status</th>
<th>Return Filed</th>
<th>Income Included</th>
<th>Deductions Allowed</th>
<th>Exemptions Allowed</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full-year Nonresident</td>
<td>Form 1040NR or 1040 NR-EZ</td>
<td>U.S. source income, other than certain interest and capital gains. Income effectively connected with a U.S. trade or business.</td>
<td>Deductions effectively connected with a U.S. trade or business, including allowable retirement contribution deductions. State and local income tax. Expenses of moving to U.S. Student loan interest. Charitable contributions to U.S. charities. U.S. casualty and theft losses.</td>
<td>Only for taxpayer except for certain taxpayers resident in Canada, Mexico or South Korea.</td>
<td>Exceptions exist for: Earned income &lt; $3,000 from non-U.S. employer if present in U.S. &lt; 90 days. Certain income of students, trainees and crew members from non-U.S. employer.</td>
</tr>
<tr>
<td>Full-year Resident</td>
<td>Form 1040, 1040A or 1040EZ</td>
<td>Worldwide income, same as U.S. citizen.</td>
<td>All deductions allowable to a U.S. citizen. Note that charitable contributions are limited to U.S. and Canadian charities. Standard deduction.</td>
<td>For taxpayer, spouse (unless MFS) and any qualifying dependent. Dependent must be U.S. citizen or resident.</td>
<td>Full-year residents are basically taxed the same as any U.S. citizen.</td>
</tr>
<tr>
<td>Dual Status—Year of Arrival</td>
<td>Form 1040 with Form 1040NR attachment</td>
<td>Worldwide income after arrival. U.S. source income pre-arrival.</td>
<td>All deductions, except standard deduction, allowable to a U.S. citizen after arrival. All deductions allowable to a non-resident pre-arrival.</td>
<td>For taxpayer, spouse (unless spouse has taxable income) and any qualifying dependent. Dependent must be U.S. citizen or resident.</td>
<td>Must file as either single or MFS. May not use MFJ or HOH.</td>
</tr>
<tr>
<td>Dual Status—Year of Departure</td>
<td>Form 1040NR with Form 1040 attachment</td>
<td>Worldwide income before departure. U.S. source income after departure.</td>
<td>All deductions, except standard deduction, allowable to a U.S. citizen before departure. All deductions allowable to a non-resident after departure.</td>
<td>For taxpayer, spouse (unless spouse has taxable income) and any qualifying dependent. Dependent must be U.S. citizen or resident.</td>
<td>Must file as either single or MFS. May not use MFJ or HOH.</td>
</tr>
</tbody>
</table>

• The services were performed while the taxpayer was a nonresident alien temporarily present in the U.S. for a period or periods of not more than 90 days during the tax year.
• The total compensation received for these services was $3,000 or less.

Other exceptions exist for crew members of a foreign vessel engaged in transportation between the U.S. and a foreign country or U.S. possession and for students and exchange visitors present in the U.S. under "F," "J" or "Q" visas whose compensation is received from foreign employers.

Special tax considerations. A nonresident alien’s U.S. source income that is not effectively connected to a trade or business has special tax considerations. This income is taxed at a flat tax rate with no deductions allowable. The standard tax rate is 30%. However, many tax treaties allow a lower treaty rate of 0%–25%. See Table 1 in IRS Pub. 901 for a full listing of the special treaty rates.

Nonresident aliens are generally not taxed on portfolio interest income from U.S. sources, as long as the income is not effectively connected with a U.S. trade or business. There are some exceptions to this rule. See IRS Pub. 519 for a list of these exceptions.

Nonresident aliens are generally not taxed on U.S. source capital gains not effectively connected with a U.S. trade or business or from the sale of U.S. real property. This exception does not apply if the nonresident alien was in the U.S. for more than 183 days during the tax year, but qualified as a nonresident under one of the visa or treaty exceptions. This exception includes long-term capital gain dividends from mutual funds. This exemption does not apply to short-term capital gain and interest-related dividends from mutual funds.

Expired Provision Alert: A provision exempting short-term capital gain and interest-related dividends received from mutual funds from U.S. tax unless the nonresident alien was present in the U.S. more than 183 days extend it to 2013. It’s possible Congress will re-examine this exception.

Care should be taken in determining whether any income of the nonresident alien is exempt by virtue of a tax treaty. If any such exemption is claimed, the amount of income and the treaty provision relied upon should be reported on page 5 of Form 1040NR.

Full-Year Resident Alien
A full-year resident alien is taxed in the same manner as a U.S. citizen, and subject to the same rules and benefits. The taxpayer may file Form 1040, 1040-A or 1040-EZ, depending on his facts and circumstances.

The main differences between a full-year resident alien and a U.S. citizen include (but are not limited to) the following:
• If the taxpayer is a full-year resident by virtue of an election made with his spouse to treat a nonresident alien as a full-year resident, he must file a joint return in the year the election is made, and may not elect married filing separate status in that initial year. See Choosing Resident Alien Status on Page 1-3.
• The taxpayer is more likely to have foreign source income and be eligible for the foreign tax credit. See more discussion on the foreign tax credit under Form 1116 (Foreign Tax Credit) on Page 6-8.
• A taxpayer’s dependent may not be eligible for the personal exemption if he is not a U.S. citizen or resident alien or a resident of Canada or Mexico.
• A taxpayer who owns a foreign rental property is subject to slightly different rules than one who owns a U.S. rental property. See Real Estate Issues on Page 1-6.

Dual Status Alien—Year of Arrival
If the taxpayer is a nonresident alien at the beginning of the tax year and a resident at the end of the tax year, he will file a dual status return. The main return will be Form 1040, with Form 1040NR included as an attachment. "Dual-Status Return" should be written across the top of the Form 1040, and "Dual-Status Statement" should be written at the top of the Form 1040NR.

Worldwide income and deductions during the residency period plus U.S. source income and deductions effectively connected with a U.S. trade or business during the period of nonresidency will be reported on Form 1040. U.S. source income and deductions during the nonresidency period will also be reported on the Form 1040NR attachment. In addition, the Form 1040NR would include any U.S. source non-trade or business income earned during the period of
contract method. The regulations apply where a long-term contract accounted for by one contractor (old contractor) using a long-term contract method is transferred to another contractor (new contractor) who is responsible for reporting income from the same contract. The regulations divide the rules for mid-contract changes into two categories, constructive completion transactions and step-in-the-shoes transactions. See Regulation §1.460-4(k) for details, including many examples.

Energy Efficient Home Builders Credit

**Expired Provision Alert.** Contractors that built new energy efficient homes in the U.S. could claim a tax credit of $2,000 per dwelling unit for homes sold after 2005 and before 2012 (IRC §45L). It’s possible that Congress will extend this provision to 2014, but it had not done so at publication time. Tax professionals should watch for developments.

Domestic Production Activities Deduction (DPAD)
The DPAD is 9% of the lesser of:

1) Qualified production activities income (QPAI) or
2) AGI (for individuals—taxable income for other entities) determined without regard to the DPAD.

The DPAD cannot exceed 50% of the wages paid and reported on Form W-2 by the business for the year. Only W-2 wages allocable to the eligible activity are counted. Taxpayers engaged in more than one activity will have to allocate wages between the activities, if all are not eligible activities.

**Caution:** The calculation of the DPAD is not optional. A taxpayer performing an eligible activity must calculate the DPAD, even if the result is zero.

**QPAI.** To determine the net income that qualifies for the 9% deduction, the taxpayer’s receipts must be divided into those from eligible activities (domestic production gross receipts, or DPGR) and non-DPGR. Then, the taxpayer’s expenses must be allocated between the two categories of income. The DPGR less allocable costs equals QPAI.

**Observation:** Although initially intended for manufacturers, the DPAD specifically applies to both construction performed within the U.S. and architectural and engineering services for U.S. construction projects.

**For more information** on the DPAD, see Tab O in the Small Business Quickfinder® Handbook. For a detailed discussion of the construction contractor specific provisions of the DPAD, see Chapter 9, Construction Contractors, in PPC’s Specialized Industry Tax Guide.

Worker Classification

In the construction industry, there are significant controversies involving the treatment of workers as employees or independent contractors (ICs). Workers treated as ICs must be issued Form 1099s if the amount paid for the year exceeds $600. For those workers treated as employees, Form W-2s must be filed. The contractor will be liable for federal income tax withholding (FITW), Social Security and Medicare (FICA) taxes on employee wages, and state and federal unemployment (FUTA) taxes.

However, the classification of workers as ICs or employees has other ramifications for the contractor. Employees generally must be covered by employer retirement plans and fringe benefit programs, whereas ICs can establish their own retirement plans or fringe benefit programs. The contractor may also be subject to a number of federal and state employment statutes.

**Preventing an IRS reclassification of ICs as employees.** Preventing a reclassification issue arising is not easy. However, there are steps that can be taken to minimize the likelihood that a reclassification battle will be fought.

- First and foremost, the contractor must file Form 1099s for all payments to individuals that exceed $600 during the year.
- The contractor should also have every worker sign a written contract spelling out the responsibilities of each party and touching on as many as possible of the 20 factors that indicate employee status (see Rev. Rul. 87-41).
- The contract should avoid using the terms hired, employee, employed and similar terms when referring to the worker.
- The contract should also set forth specific completion dates and contain damages clauses in case of nonperformance.
- The worker should furnish his own tools and materials, and the contractor should require each worker to provide a copy of his business license, liability insurance coverage and bonding.
- The contractor should structure payment on a piecework or similar method, avoiding hourly, weekly or monthly pay.
- The agreement may also contain language that the worker (1) must hire and supervise any helpers or assistants, (2) can establish his own schedule as long as contract deadlines are met, (3) will not undergo training by the contractor and (4) is not providing services exclusively to the contractor. The agreement should also include detailed termination provisions that do not allow the contractor to terminate the agreement at will.
- Finally, the contractor should avoid paying the worker’s expenses, except as provided for in the contract. Those that are paid should be included in the worker’s contract price.

**For more information** on worker classification, see Independent Contractors in Tab 6 of the 1040 Quickfinder® Handbook. For a detailed discussion of the construction contractor specific issues in worker classification, see Chapter 9, Construction Contractors, in PPC’s Specialized Industry Tax Guide.
Net Operating Loss (NOL) Carrybacks

In general, an NOL is carried back to the two prior tax years. However, the Code provides a special five-year carryback period for farming losses. [IRC §172(b)(1)(G)]

The amount available for the special five-year farm carryback is the smaller of the NOL if only items attributable to a farming business are taken into account or the regular NOL for the year. A farming business is a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. This definition includes the businesses of operating a nursery or sod farm, the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. The raising, shearing, feeding, caring for, training and management of animals is also a farming business.

If a farmer entitled to a five-year NOL carryback elects to decline the privilege, the normal NOL carryback rules apply [IRC §172(i)(3)]. In some cases, a farmer might wish to decline all carryback periods, in order to carry the NOL to future tax years.

Debt Cancellation

Full or partial cancellation of a debt is generally considered income for tax purposes. See Debt Cancellation on Page 1-18 for exceptions and Tab 6 in the 1040 Quickfinder® Handbook regarding a special exclusion for qualified farm indebtedness.

Qualified Conservation Contribution

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization to be used only for conservation purposes. For definitions of the preceding italicized terms, see Pub. 526, Charitable Contributions. A landowner who grants a conservation easement is eligible for a charitable contribution deduction. The allowable deduction is generally the amount by which FMV of the property drops as a result of the easement. To qualify, easement rights must be granted in perpetuity and must be granted to a qualified organization or governmental unit or local land trust.

A special de minimis rule lets a taxpayer consider all of his farm gross receipts as qualifying DPGR if the nongenerating portion is less than 5% of total gross receipts. [Reg. §1.199-3(i)(1)(iii)]

Wage limitation. Wages for the 50% limitation may be calculated under any one of three methods (see Rev. Proc. 2006-47). Essentially, the business wages of the taxpayer must be those subject to payroll taxes and insurance and properly reported on a Form W-2. Many Schedule F proprietors, who would otherwise qualify for the DPAD, will lack wages and not be able to claim the deduction. In these cases, there may be services provided by family members that could be compensated, to overcome the wage limitation. However, the extra payroll taxes and insurance costs to formalize these previously uncompensated services must be compared to the income tax savings from the DPAD.

Small business simplified allocation method. A taxpayer must allocate business expenses to qualifying DPGR to calculate QPAI on which the 9% computation is made.

Cooperatives. Co-ops engaged in the manufacturing, production, growth, extraction or marketing of agricultural or horticultural products may claim the DPAD [IRC §199(d)(3)]. Any DPAD incurred...
by the co-op is allocated to the patron based upon the patron’s share of patronage dividends or per-unit retains attributable to the co-op’s QPAI. To claim the patron’s deduction from box 6 of Form 1099-PATR, this amount must have been identified by the co-op in a written notice mailed to the patron during the payment period. The patron’s deduction is claimed by entering the amount from box 6 of Form 1099-PATR on line 23 of Form 8903, Domestic Production Activities Deduction.

AG Labor and Rural Jobs Tax Credit

Expired Provision Alert: The Work Opportunity Tax Credit expired at the end of 2011. It’s possible Congress will extend it to 2012, but had not done so at the time of this publication.

The Work Opportunity Tax Credit (WOTC) under Section 51 allows a credit for employing a qualified rural renewal county resident. The credit is up to $2,400 for each eligible hire. The credit is requested by filing Form 8850, Pre-screening Notice and Certification Request for Work Opportunity Credit, at the time the employee is hired. If the credit is approved, it is claimed by filing Form 5884, Work Opportunity Credit, with the taxpayer’s Form 1040. For additional information on the Work Opportunity Credit, see Pub. 954.

Example With Filled-In Forms

The following example illustrates the filing of Form 1040 and other required forms and schedules for a typical farmer.

The Facts
Zeke West is a dairy farmer filing jointly with his wife, Zelda, for the 2012 calendar year, using the cash method of accounting. Zeke receives payment by cash or check only.

Form 4562—Depreciation and Amortization (Not Shown):
Zeke follows the instructions and lists the information called for in Parts I through IV. He also completes Part V on page 2 to provide information on listed property (two vehicles) used in his farming business.

Form 8903—Domestic Production Activities Deduction (Not Shown):
Zeke’s Form 8903 was prepared using the small business simplified overall method. See Domestic Production Activities Deduction (DPAD) on Page 6-33.

Schedule SE—Self-Employment Tax (Not Shown):
After figuring his net farm profit on Schedule F, Zeke figures his SE tax on Short Schedule SE, Section A. He is not required to use Long Schedule SE. Zelda has no SE income. If she did, she would file her own Schedule SE.

Form 4684—Casualties and Thefts (Not Shown):
Zeke’s only business casualty occurred on July 7 when a dairy cow he purchased four years ago was killed by lightning. He shows the loss from the casualty on page 2 of Form 4684.

Form 4797—Sales of Business Property (Not Shown):
After completing Schedule F and Section B of Form 4684, Zeke fills in Form 4797 to report his sales of business property. Before he can complete Parts I and II, he must complete Part III to report the sale of depreciable property.

Schedule D—Capital Gains and Losses (Not Shown):
After completing Form 4797, Zeke fills in Schedule D. After he completes his Form 1040 through line 43, he will use Schedule J, Income Averaging for Farmers and Fishermen, to determine if it yields the lowest tax.

Zeke’s 2012 Schedule F Transactions and Reporting

<table>
<thead>
<tr>
<th>Sch F Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1b..........</td>
<td>Sale of steers bought for resale...........</td>
<td>$ 13,596</td>
</tr>
<tr>
<td>1d..........</td>
<td>Cost of steers sold..................................</td>
<td>&lt; 8,923&gt;</td>
</tr>
<tr>
<td>2b..........</td>
<td>Sales of items raised or produced:</td>
<td></td>
</tr>
<tr>
<td>.............</td>
<td>Milk..........................................................</td>
<td>233,874</td>
</tr>
<tr>
<td>.............</td>
<td>Calves raised for resale..........................</td>
<td>2,914</td>
</tr>
<tr>
<td>.............</td>
<td>Vegetables..................................................</td>
<td>1,457</td>
</tr>
<tr>
<td>.............</td>
<td>Corn, Hay and Wheat..................................</td>
<td>24,773</td>
</tr>
<tr>
<td>3a and 3b...</td>
<td>Cooperative patronage dividend (qualified written notice of allocation)</td>
<td></td>
</tr>
<tr>
<td>.............</td>
<td>..........................................................</td>
<td>1,145</td>
</tr>
<tr>
<td>4a and 4b...</td>
<td>FSA cost-sharing payments (materials and services)</td>
<td></td>
</tr>
<tr>
<td>.............</td>
<td>on conservation project—reported on Form 1099-G-..</td>
<td>6,781</td>
</tr>
<tr>
<td>5a..........</td>
<td>CCC loan received—income method................</td>
<td>665</td>
</tr>
<tr>
<td>7b..........</td>
<td>Custom harvesting income (hay baling)...........</td>
<td>1,258</td>
</tr>
<tr>
<td>8b..........</td>
<td>Credit taken on 2011 return for excise taxes on farm-use gasoline</td>
<td>142</td>
</tr>
<tr>
<td>9..........</td>
<td>Sch F Gross Income......................................</td>
<td>$ 280,082</td>
</tr>
</tbody>
</table>

Schedule F Expenses:

<table>
<thead>
<tr>
<th>Schedule F Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>10..........</td>
</tr>
<tr>
<td>11..........</td>
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<tr>
<td>12..........</td>
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<td>31..........</td>
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<tr>
<td>32..........</td>
</tr>
<tr>
<td>33..........</td>
</tr>
<tr>
<td>9-33........</td>
</tr>
</tbody>
</table>

Form 1040:

- **Line 7.** Zelda worked for Zeke on the farm during 2012. He enters on line 7 her total wages, $8,950, as shown on the Form W-2 that he gave her.
- **Lines 8a and 9a.** Zeke earned bank interest of $2,618. He received patronage dividends from farmers’ cooperatives based on business done with the co-ops. He does not list these dividends here, but on Schedule F, lines 3a and 3b.
- **Lines 13, 14 and 18.** Zeke previously carried these items from other forms.
- **Line 27.** Zeke carried his SE tax deduction, $4,496, from Schedule SE.
Nontaxable combat pay election. Members can elect to have their nontaxable combat pay included in earned income for the EIC by including the nontaxable combat pay on line 64b of Form 1040. If the election is made, all nontaxable combat pay received must be included in earned income. Taxpayers filing a joint return in which both spouses received nontaxable combat pay can each make their own election. The amount of nontaxable combat pay should be shown on Form W-2 in box 12 with code Q. Electing to include nontaxable combat pay in earned income may increase or decrease the EIC.

Practice Tip: Calculate the credit with and without the nontaxable combat pay before making the election. Whether the election increases or decreases the EIC depends on total earned income, filing status and number of qualifying children.

Example #1: George and Janice are married and will file a joint return. They have one qualifying child. George was in the Army and earned $11,000 ($5,000 taxable wages + $6,000 nontaxable combat pay). Janice worked part of the year and earned $2,000. Their taxable earned income and AGI are both $7,000. George and Janice qualify for the earned income credit. Without adding the nontaxable combat pay to their earned income, their credit is $2,389. If the nontaxable combat pay is added to their earned income, their credit is $3,169. Because making the election will increase their EIC, they elect to add the nontaxable combat pay to their earned income for the EIC.

Example #2: The facts are the same as in Example 1 except George had nontaxable combat pay of $21,000. When George’s nontaxable combat pay is added to their earned income, their credit is $2,254. Because the credit they can get by not adding the nontaxable combat pay to their earned income is $2,389, they decide not to make the election.

Child Tax Credit and Additional Child Tax Credit

Taxpayers with one or more qualifying children may be able to claim a child tax credit of up to $1,000 per qualifying child. The child tax credit is generally a nonrefundable credit that is limited to regular tax liability plus alternative minimum tax (AMT) liability. The additional child tax credit allows a portion of the child tax credit to be refundable for certain taxpayers.

Military service exception to the residency test. To be eligible for the child tax credit, a qualifying child must have lived with the taxpayer for more than one-half of the year. Temporary absences for military service count as time lived at home.

Earned income. For the additional child tax credit, taxable earned income is generally defined the same as for the EIC [in Section 32(c)(2)]. Nontaxable combat pay excluded from gross income under Section 112 is included in earned income for calculating the additional child tax credit. [IRC §24(d)(1)]

Differential Wage Credit for Small Business Employer

An Expired Provision Alert: The differential wage credit for small business employers expired at the end of 2011. It’s possible Congress will extend it to 2012, but had not done so at the time of this publication.

An eligible small business (employing less than 50 employees with a written plan providing for differential payments (see Military Differential Pay on Page 7-8) was formerly able to claim a credit equal to 20% of up to $20,000 of differential wages paid to each qualifying employee during the tax year (IRC §45P). The credit was available for payments made after June 17, 2008 and before 2012. The employer’s salary deduction must be decreased by an amount equal to the credit.

The credit was claimed on Form 8932, Credit for Employer Differential Wage Payments. The credit was also reported on Form 3800, General Business Credit.

First-Time Homebuyer Credit

Members serving outside the U. S. had an extra year to purchase a principal residence and still qualify for the credit. See Tab 12 in the 1040 Quickfinder® Handbook for details on the credit.

Generally, the credit must be recaptured if the taxpayer disposes of the residence, or the residence ceases to be the taxpayer’s principal residence, during the 36-month period beginning on the date of purchase. However, special rules apply to members of the armed forces. If a member disposes of or ceases to use a principal residence after December 31, 2008, in connection with government orders (received by the taxpayer or spouse) for qualified official extended duty service, he will be exempt from the recapture provision for a residence purchased before January 1, 2009.

TAX FORGIVENESS OF MILITARY DECEDENT’S TAX LIABILITY

Tax liability can be forgiven, or if already paid, refunded, if a member dies: (IRC §692)

• While in active service in a combat zone;
• From wounds, disease or other injury received in a combat zone or
• From wounds or injury incurred in a terrorist or military action. Tax for the year of death and possibly for earlier years can be forgiven. In addition, any unpaid tax liability at the date of death may be forgiven (does not have to be paid).

If a member dies, a surviving spouse or personal representative handles duties such as filing any tax returns and claims for refund of withheld or estimated tax. A personal representative can be an executor, administrator or anyone who is in charge of the decedent’s assets.

Joint returns. Only the decedent’s part of the joint income tax liability is eligible for the refund or tax forgiveness. To determine the decedent’s part, the person filing the claim must: (Reg. §1.692-1(b))

1) Figure the income tax for which the decedent would have been liable if a separate return had been filed,

Continued on the next page
Example #2: Earvin, a cash basis individual who has elected to currently deduct IDC (as discussed at IDC—definition and tax treatment below), is engaged in oil and gas exploration and production. Drilco is a drilling contractor that drills some of the wells for Earvin (the price is determined on an arm’s-length basis).

Drilco has cash flow problems. In November, Drilco enters into a drilling contract with Earvin, under which Drilco will drill a well on Tract D, where the entire working interest is held by Earvin. The tumkey price is $750,000 for a producing well, with $625,000 being designated for drilling costs. This amount is also designated as the total dry hole costs if the well should prove to be nonproductive. To help with Drilco’s cash flow problems, the contract requires Earvin to prepay, in December, $500,000 towards the intangible portion of the contract. As of year end, $300,000 of IDC has been incurred on the well.

Earvin should be able to take a current-year deduction for the $500,000 payment. All of the prerequisites for a deduction appear to be present.

IDC—definition and tax treatment. Frequently, the largest single cost incurred by a working interest owner is the IDC. For tax purposes, IDC is any cost incurred that in itself has no salvage value and is incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. These costs include wages, fuel, repairs, hauling and supplies. [Reg. §1.612-4(a)]

Expense. In the first year IDC is incurred, the taxpayer may elect to currently deduct IDC [IRC §263(c)]. If the election is made, the taxpayer generally must deduct IDC in all subsequent years as it is paid or incurred for all properties. However, he can still make an annual election under Section 59(e) to capitalize and amortize over 60 months some or all of the IDC incurred that year.

Capitalize. If the Section 263(c) election is not made, IDC is capitalized and recovered through cost depletion or depreciation if the cost represents physical property.

A taxpayer who does not elect to expense IDC may still elect to expense IDC on nonproductive wells (dry holes). The deduction is allowable only in the year the wells are completed as dry holes [Reg. §1.612-4(b)(4)]. Even when some costs were incurred in one year and the outcome of the well is known by the time that year’s tax return is filed, the costs may not be deducted until the year the well is completed.

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

Assets used in drilling oil and gas wells (for example, drilling rigs) are generally depreciable using a five-year MACRS recovery period. (See Tab 10 in the 1040 Quickfinder® Handbook or IRS Publication 946.) Assets used during the production phase and during operation, such as gathering pipelines, pumps and related storage facilities, are depreciated using a seven-year MACRS recovery period. Rather than depreciate the property, however, taxpayers can elect to expense such costs under Section 179, provided the other Section 179 conditions are met. Claiming a Section 179 deduction for L&W can greatly simplify recordkeeping and accelerate deductions.

An additional 50% (100% if acquired and placed in service September 9, 2010–December 31, 2011) special (bonus) depreciation allowance is available for assets meeting the following requirements:

1) MACRS recovery period of 20 years or less,
2) New assets (not used) and
3) Purchased and placed in service before 2013.

Depletion. A working interest owner is entitled to a deduction for the greater of cost depletion (IRC §612) or allowable percentage depletion (sometimes called statutory depletion—IRC §613A). Cost depletion is based on the LHC of the property and is calculated using the mineral reserves (obtained from engineering reports) and the number of units sold for the year [Reg. §1.611-2(a)]. For cash-basis taxpayers, the “number of units sold” means units for which payment was actually received within the tax year. Cost depletion is similar to depreciation determined on a units-of-production method.

Practice Tip: For cost depletion purposes, natural gas production is converted into equivalent barrels of oil using a ratio of 6,000 cubic feet (6 MCF) of gas to one barrel of oil. [IRC §613A(c)(4)]

Cost Depletion Calculation

<table>
<thead>
<tr>
<th>Unrecovered depletible costs</th>
<th>Estimated recoverable reserves (in units) at beginning of year</th>
<th>Units Sold</th>
<th>Cost Depletion</th>
</tr>
</thead>
</table>

Example continued on the next page
Cash Payment Reporting Requirement
Any business receiving more than $10,000 in cash in any one transaction (or two or more related transactions) must file Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business, within 15 days of the cash transaction [IRC § 6050I(a)]. For these purposes, transactions are related if they are conducted within a 24-hour period, or if the business knows or has reason to know that each transaction is one in a series of related transactions.

Cash includes U.S. coin and currency and foreign currency [IRC § 6050I(d)]. Cashier’s checks, bank drafts, traveler’s checks and money orders having a face value of not more than $10,000 must be reported where meeting a designated reporting transaction test or received in a transaction in which the business knows the cash is being used in an attempt to avoid the reporting of the transaction. Designated reporting transactions include the retail sale of consumer durables, collectibles or travel and entertainment activities. [Reg. § 1.6050I-1(c)]

Example: Krooked has his daughter’s wedding reception at the Indigestion Restaurant at a cost of $11,000. He pays for the reception with cash (U.S. currency). Since the reception occurs in Indigestion’s trade or business and the payment involves cash in excess of $10,000, Form 8300 must be filed for this transaction.

Variation: Now assume that Krooked pays for the reception with two $5,500 cashier checks and tells the Indigestion manager that he is doing so to avoid the Form 8300 filing requirement. Even though the checks individually are $10,000 or less, the restaurant knows that the transaction is structured to avoid the Form 8300 reporting requirements. Indigestion must file a Form 8300 reporting the transaction.

DEPRECIATION AND AMORTIZATION
Restaurants are subject to the normal depreciation rules, including Section 179 expensing and the special depreciation allowance. However, special rules may apply to qualified restaurant property and leasehold improvements.

15-Year Recovery Period for Certain Real Property
- **Qualified leasehold improvement property** is a leasehold improvement property that also meets the definition of a qualified leasehold improvement property only if the improvement is held by that person. How- ever, there are certain events that do not cause qualified leasehold improvements made by the lessor to lose their status (for example, death, Section 1031 exchanges, etc.). [IRC § 168(e)(6)(B)]

For 2012, Congress will extend the 15-year recovery period to 2012, but it had not done so at the date of this publication. Tax professionals should be alert for developments.

Restaurant Owners may elect to currently deduct some or all of the cost of qualifying property that would otherwise be subject to depreciation. The Section 179 deduction is limited to a maximum annual amount ($500,000 for 2012). The deduction is also limited by taxable income and is scaled back when the taxpayer places more than a certain amount ($2,000,000 for 2012) of Section 179 property in service during the tax year.

Special (Bonus) Depreciation
For most qualifying assets placed in service in 2012, the special (bonus) depreciation rate is 50%.

- **Qualified restaurant property** (see Qualified restaurant property in the previous column) is not eligible for the special depreciation allowance [IRC § 168(e)(7)(B)]. Exception: Qualified restaurant property that also meets the definition of a qualified leasehold improvement is eligible for special depreciation.

Section 179 Expense
- **Qualified leasehold improvement property** is a leasehold improvement that is:
  1. Made to an interior portion of a nonresidential building;
  2. Made pursuant to a lease by either the lessee, sublessee or the lessor to property that is to be occupied exclusively by the lessee or sublessee and
  3. Placed in service more than three years after the date the building was first placed in service.

An improvement made by the lessor is qualified leasehold improvement property only if the improvement is held by that person. However, there are certain events that do not cause qualified leasehold improvements made by the lessor to lose their status (for example, death, Section 1031 exchanges, etc.). [IRC § 168(e)(6)(B)]

Amortizing Intangibles
A significant portion of the restaurant industry is comprised of franchised restaurants. The acquisition of a franchise is governed by Section 197 and therefore the cost of a franchise is amortized ratably over 15 years. The 15-year amortization period applies regardless of the actual useful life of the Section 197 intangible. Franchise renewals must also be amortized over 15 years. For
Assets Used in a Retail Business—Five Year Recovery Period (Continued)

<table>
<thead>
<tr>
<th>Asset</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail furniture</td>
<td>Includes furniture unique to retail stores and distinguishable from office furniture. For example, a high stool in a cosmetic department, a shoe department footstool, a hair salon barber chair, or a bench outside a dressing room.</td>
</tr>
<tr>
<td>Ripening rooms</td>
<td>Special enclosed equipment boxes used to ripen produce by circulating special gases. The rooms are large boxes with special doors and large airplane-type propellers, which circulate the gases used to ripen the produce. The boxes are housed within a distribution center warehouse. These specialized facilities are considered to be part of the retail distribution equipment because they have a special retail purpose and can not be used for any other purpose. The boxes are not a part of the building structure.</td>
</tr>
<tr>
<td>Security systems</td>
<td>Electronic article surveillance systems including electronic gates, surveillance cameras, recorders, monitors and related equipment, the primary purpose of which is to minimize merchandise shrinkage due to theft. Also includes teller-style pass-through windows, security booths, and bulletproof enclosures generally located in the cash office and customer service areas.</td>
</tr>
<tr>
<td>Signs</td>
<td>Interior and exterior signs used for display or theme identity. For example, interior signs to identify departments or exterior signs to display trade names or trade symbols. For pylon signs, includes only sign face.</td>
</tr>
<tr>
<td>Sound systems</td>
<td>Equipment and apparatus, including wiring, used to provide amplified sound or music. For example, public address way by which paging a customer or background music. Excludes applications linked to fire protection and alarm systems.</td>
</tr>
<tr>
<td>Wall coverings</td>
<td>Strippable wallpaper that causes no damage to the underlying wall or wall surface.</td>
</tr>
<tr>
<td>Walls—interior partitions</td>
<td>Interior walls for merchandise display where the partition can be (1) readily removed and remain in substantially the same condition after removal as before (2) moved and reused, stored or sold in their entirety.</td>
</tr>
<tr>
<td>Window treatments</td>
<td>Window treatments such as drapes, curtains, louver, blinds, post construction tinting and interior decorative theme décor which are readily removable.</td>
</tr>
</tbody>
</table>

**Practice Tip:** In its Audit Technique Guide for Cost Segregation, the IRS lists assets assigned a five-year recovery period because they are used in the retail business (Class 57.0 assets per Rev. Proc. 87-56). Many of these assets are part of or attached to a building and thus may be incorrectly depreciated over 39 years.

**Qualified Retail Improvement Property**

For 2014, generally, building improvements are depreciated over 39 years. However, qualified retail improvement property placed in service in 2011 qualifies for 15-year, straight-line depreciation [IRC §168(e) (3)(E)(ix)]. Qualified retail improvement property is any property improvement to an interior portion of a building that is nonresidential real property if: (1) that portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and (2) that improvement is placed in service more than three years after the date the building was first placed in service [IRC §168(e)(8)(A)]. Qualified retail improvement property is not eligible for additional first-year 50% bonus depreciation, and the following improvements are not included: (1) the enlargement of the building, (2) any elevator or escalator, (3) any structural component benefiting a common area or (4) the internal structural framework of the building. [IRC §168(e)(8)(C)]

Gas Stations and Convenience Stores

Buildings and land improvements used primarily in the marketing of petroleum and petroleum products are classified as 15-year property under Rev. Proc. 87-56 (Asset Class 57.1). So, traditional gasoline service station buildings (that is, no convenience store attached) and related land improvements, including billboards and car washes, qualify as 15-year property.

Underground storage tanks, fuel dispensing pumps and other automobile service equipment are typically considered personal property and assigned a five-year recovery period under Rev. Proc. 87-56 (Asset Class 57.0).

**Observation:** A service station building that is movable personal property is property used in the retail business and assigned a five-year recovery (Asset Class 57.0). Generally, only smaller structures (such as kiosks) will qualify. The critical factors are whether the structure is easily movable and constructed in a manner that reflects anticipation of the structure having to be moved. Even if there is no plan to move a modular structure, it is still assigned a five-year recovery period.

**Retail motor fuels outlet.** Depreciable real property that is a retail motor fuels outlet is 15-year property [IRC §168(e)(3)(E)(ii)]. However, a retail motor fuels outlet is not eligible for the Section 179 deduction since it is Section 1250 property.

**Note:** A building used for a business activity (such as a restaurant or convenience store) in addition to selling gas (or other petroleum-related products) doesn’t qualify as an asset used primarily in the marketing of petroleum and petroleum products (Asset Class 57.1). Thus, it must be depreciated over 39 years unless it can qualify as a retail motor fuels outlet. (Rev. Proc. 88-22)

Real property is a retail motor fuels outlet if it is used to a substantial extent in the retail marketing of petroleum (or petroleum products) and meets any one of the following three tests:

- It is 1,400 square feet or less.
- 50% or more of the gross revenues generated from the property are derived from petroleum sales.
- 50% or more of the floor space in the property is devoted to petroleum marketing activity.

For purposes of determining whether a building qualifies as a retail motor fuels outlet, gross revenue includes all excise and sales taxes.

A retail motor fuels outlet qualifies as 15-year property regardless of whether the owner is also the operator. However, the owner has to include the gross revenue of all businesses operated in the outlet building for the 50% test. (Rev. Rul. 97-29)
Other AOTC requirements:
- **Degree requirement.** Student must be enrolled in a program that leads to a degree, certificate or other recognized educational credential.
- **Work load.** Student must take at least half of the normal full-time work load for the student’s course of study for at least one academic period beginning during the tax year.
- **No felony drug conviction.** Student must be free of any felony conviction for possessing or distributing a controlled substance.
- **Modified AGI phase-outs** [IRC Sec. 25A(i)(4)]. The AOTC phases out for modified AGI between $160,000 and $180,000 for married joint filers and $80,000 to $90,000 for other qualified taxpayers.

Lifetime Learning Credit
The Lifetime Learning Credit (LLC) is a non-refundable tax credit of 20% of up to $10,000 of qualified tuition and fees paid during the tax year. Maximum credit is $2,000 per return.

Other lifetime learning credit requirements:
- **Credit not workload-based.** Allowed regardless of the number of courses taken.
- **Both degree and nondegree courses eligible.** Available for undergraduate, graduate, professional degree students and students acquiring or improving their job skills.
- **Unlimited number of years.** There is no limit on the number of years for which the credit can be claimed for each student.
- **Per return per year.** The credit does not vary based on the number of students in a family.
- **Modified AGI phase-outs** (Rev. Proc. 2011-52). For 2012, the lifetime learning credit phases out for modified AGI between $104,000 and $124,000 for married joint filers and $52,000 to $62,000 for other qualified taxpayers.

**Example:** Pam, a professional photographer, enrolls in an advanced photography course at a local college. The course is not part of a degree program, but Pam enrolls to improve her job skills. The expense qualifies for the LLC (provided Pam does not claim a business expense for it).

AMT and the Education Tax Credits
For 2012, the LLC cannot offset the alternative minimum tax [IRC §26(a)(1)].--The AOTC is allowed against AMT in 2012 [IRC § 25A(i)(5)].

**Expired Provision Alert:** In 2011, the LLC was also allowed as a credit against AMT. It’s possible Congress will extend this provision to 2012, but had not done so at the time of this publication. Taxpayers should be alert for developments.

Coordination of Credits and Exclusions
Education credits. A taxpayer may not claim both an AOTC and an LLC for the same student in the same year.

Education savings account (ESA) and qualified tuition program (QTP). A taxpayer can claim the AOTC or LLC in the same year that the taxpayer excludes an ESA or QTP distribution from income as long as the same expenses are not used for both benefits. Qualified education expenses (QEE) are reduced in the following order:
1) Amounts excluded from income such as scholarships and employer-provided education assistance then
2) Amounts used to claim education credits such as the AOTC and lifetime learning credits.

Thus, if an education credit is claimed, QEE are first allocated to the credit, and any remaining QEE go toward computing the taxable amount of the distribution.

If a student receives distributions from both an ESA and a qualified tuition program that are more than the remaining expenses, the expenses must be allocated between the distributions.

**Tuition and fees deduction (if extended to 2012).** A taxpayer may not claim the qualified tuition and fees deduction if the AOTC or LLC is claimed for the same student in the same year [IRC §222(c)(2)(A)]. The taxpayer may claim either the credit or the deduction, whichever is more advantageous.

Education savings bond program. The amount of education expenses used to compute the AOTC or LLC reduces the amount used in computing the exclusion of interest on Series EE or Series I U.S. savings bonds. [IRC §135(d)(2)]

Educational assistance program. Qualified education expenses are reduced by any tax-free educational assistance received.

**Form 1098-T**
To help compute the education credits, taxpayers should receive Form 1098-T from the educational institution by January 31 of the following year. An institution may choose to report either payments received (box 1), or amounts billed (box 2), for qualified education expenses. Only amounts actually (or deemed) paid by the taxpayer can be used to claim the credit. In addition, Form 1098-T should provide other information for that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds and whether the student was enrolled at least half-time or was a graduate student.

The eligible educational institution may ask for a completed Form W-9S, Request for Student’s or Borrower’s Taxpayer Identification Number and Certification, or similar statement to obtain the student’s name, address and taxpayer identification number.

### Comparing the Education Credits (2012)

<table>
<thead>
<tr>
<th></th>
<th>American Opportunity Tax Credit</th>
<th>Lifetime Learning Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $2,500 credit per eligible student.</td>
<td></td>
<td>Up to $2,000 credit per return.</td>
</tr>
<tr>
<td>Available for the first four years of post-secondary education.</td>
<td>Available for all years of postsecondary education and for courses to acquire or improve job skills.</td>
<td></td>
</tr>
<tr>
<td>Available only for four years per eligible student.</td>
<td>Available for an unlimited number of years.</td>
<td></td>
</tr>
<tr>
<td>Student must be pursuing an undergraduate degree or other recognized education credential.</td>
<td>Student does not need to be pursuing a degree or other recognized education credential.</td>
<td></td>
</tr>
<tr>
<td>Student must be enrolled at least half time for at least one academic period beginning during the year.</td>
<td>Available for one or more courses.</td>
<td></td>
</tr>
<tr>
<td>No felony drug conviction on student’s record.</td>
<td>Felony drug conviction rule does not apply.</td>
<td></td>
</tr>
</tbody>
</table>

**Example—Claiming Both Education Credits on Return**
Carter and Ann Wiggins are married and file a joint tax return. For 2012, they claim exemptions for their two dependent children and their modified AGI is $98,000. Their itemized deductions consist of $42,000 mortgage interest and charitable contributions. Assume their tax, before credits, is $5,300 and that they will not be subject to AMT. Their son, Stanley, will receive his graduate (post-four year) degree in psychology from State College in May 2013. Their daughter, Claire, enrolled full-time at State College in August 2011 to begin working on her bachelor’s degree in physical education. In July 2012, the Wiggins paid $2,200 in tuition costs for each child for the Fall 2012 semester. In December 2012, they also paid $2,600 of tuition for each child for the Spring 2013 semester that begins...
<table>
<thead>
<tr>
<th>IRC §</th>
<th>American Opportunity Credit</th>
<th>Lifetime Learning Credit</th>
<th>IRA Withdrawals</th>
<th>Savings Bond Interest Exclusion</th>
<th>Student Loan Interest Deduction</th>
<th>Tuition and Fees Deduction</th>
<th>Qualified Tuition Program (QTP) (529 Plan)</th>
<th>Education Savings Account (ESA)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25A</td>
<td>25A</td>
<td>72(t)</td>
<td>135</td>
<td>221</td>
<td>222</td>
<td>529</td>
<td>530</td>
</tr>
<tr>
<td>Tax Benefit</td>
<td>Tax credit—</td>
<td>40% refundable; 60% nonrefundable.</td>
<td>Tax credit—</td>
<td>10% early withdrawal penalty is waived.</td>
<td>Tax-free interest.</td>
<td>Above-the-line tax deduction.</td>
<td>Above-the-line tax deduction.</td>
<td>Tax-free earnings (savings plan) or tax-free education credits (prepaid plan).</td>
</tr>
<tr>
<td>2012 Annual Limits</td>
<td>Credit up to $2,500 per student (100% of first $2,000 of expenses and 25% of next $2,000).</td>
<td>Credit up to $2,000 per return (20% of up to $10,000 of expenses).</td>
<td>Amount of qualifying expenses.</td>
<td>Amount of qualifying expenses.</td>
<td>Deduction of up to $2,500 of interest paid on education loan.</td>
<td>Deduction of up to $4,000 of qualifying expenses paid.</td>
<td>Nondeductible contributions limited to amount necessary to cover qualified expenses.</td>
<td>$2,000 nondeductible contribution per child under age 18 or any age if special-needs child.</td>
</tr>
<tr>
<td>Qualified Education Expenses (QEE)</td>
<td>Tuition and fees; books, supplies and equipment.</td>
<td>Tuition and fees; books, supplies and equipment.</td>
<td>Tuition and fees; books, supplies and equipment; room and board if at least half-time attendance.</td>
<td>Tuition and fees; contributions to QTPs and ESAs.</td>
<td>Tuition and fees; books, supplies and equipment.</td>
<td>Tuition and fees; book, supplies and equipment.</td>
<td>Tuition and fees; books, supplies and equipment; room and board if at least half-time attendance; payments to QTP.</td>
<td></td>
</tr>
<tr>
<td>QEE Must Be For</td>
<td>Taxpayer, spouse or dependent.</td>
<td>Taxpayer, spouse or dependent.</td>
<td>Taxpayer, spouse, child or grandchild.</td>
<td>Taxpayer, spouse or dependent.</td>
<td>Taxpayer, spouse or dependent.</td>
<td>Taxpayer, spouse or dependent.</td>
<td>Account beneficiary.</td>
<td>Account beneficiary.</td>
</tr>
<tr>
<td>Qualifying Education</td>
<td>First four years of undergraduate.</td>
<td>Undergraduate and graduate.</td>
<td>Undergraduate and graduate.</td>
<td>Undergraduate and graduate.</td>
<td>Undergraduate and graduate.</td>
<td>Undergraduate and graduate.</td>
<td>Undergraduate and graduate.</td>
<td>K–12, undergraduate and graduate.</td>
</tr>
<tr>
<td>Other Rules and Requirements</td>
<td>Must be enrolled at least half-time in a degree program; parents can shift credit to student by not claiming student as a dependent.</td>
<td>Available for unlimited number of years for both degree and non-degree programs; parents can shift credit to student by not claiming student as a dependent.</td>
<td>Penalty waived on IRA distributions up to the amount of qualified expenses for the year.</td>
<td>Applies only to qualified Series EE bonds issued after 1989 or Series I bonds; bond owner must be at least 24 years old when bond issued.</td>
<td>Loan must be incurred solely to pay qualified education expenses of student enrolled at least half-time in a degree program. Payer must be legally obligated to repay debt.</td>
<td>Not allowed if education expenses are deducted under another provision or education credit is claimed.</td>
<td>Account owner can change beneficiary or reclaim funds; can elect to spread gift over five years; some states allow deduction to residents; beneficiary can be anyone.</td>
<td>Contributions must be made by the original return due date; may also contribute to QTP; mandatory distributions at age 30; beneficiary can be anyone.</td>
</tr>
<tr>
<td>2012 Modified AGI Phase-Out</td>
<td>MFJ...............................</td>
<td>$160,000 – 180,000</td>
<td>$104,000 – 124,000</td>
<td>N/A</td>
<td>$109,250 – 139,250</td>
<td>$125,000 – 155,000</td>
<td>Not allowed if MAGI exceeds:</td>
<td>N/A</td>
</tr>
<tr>
<td>Single, HOH, QW*....</td>
<td>80,000 – 90,000</td>
<td>52,000 – 62,000</td>
<td>72,850 – 87,850</td>
<td>60,000 – 75,000</td>
<td>80,000</td>
<td>80,000</td>
<td>N/A</td>
<td>$95,000 – 110,000</td>
</tr>
<tr>
<td>MFS .....................</td>
<td>Do Not Qualify</td>
<td>Do Not Qualify</td>
<td>Do Not Qualify</td>
<td>Do Not Qualify</td>
<td>Do Not Qualify</td>
<td>Do Not Qualify</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

1. Expired Provision Alert: The tuition and fees deduction expired at the end of 2011. It’s possible Congress will extend the provision to 2012, but had not done so at the time of this publication.
3. Qualifying educational expenses must be reduced by any tax-free scholarships and grants. The same educational expenses cannot be used for figuring more than one benefit.
4. Must be required for enrollment or attendance at an eligible educational institution.
5. Must be paid to the eligible educational institution as a condition of the student’s enrollment or attendance at the institution.
6. For K-12th grade, uniforms, transportation, supplementary items and certain computer equipment and internet access also qualify.
7. No AGI phase-out range. Up to $4,000 is deductible if MAGI does not exceed $65,000 ($130,000 for MFJ). Up to $2,000 is deductible if MAGI does not exceed $80,000 ($160,000 for MFJ).
8. For savings bond interest exclusion, QW is subject to the same phase-out range as MFJ.
1040 Reporting
Schedule C. Since they are treated as independent contractors, qualified real estate agents report their income and deductions on Schedule C of Form 1040. (Pub. 334)

Schedule SE. Since they are treated as self-employed for all purposes, qualified real estate agents are also liable for self-employment taxes. Therefore, their net income from Schedule C is carried to Schedule SE.

TEACHERS

Educator's Expense Deduction

Expired Provision Alert: The educator’s expense deduction expired at the end of 2011. It’s possible Congress will extend it to 2012, but had not done so at the time of this publication.

For 2011, an eligible educator was allowed an above-the-line deduction of up to $250 for classroom expenses paid during the tax year [IRC §62(a)(2)(D)]. Taxpayers who were both eligible educators and filing a joint return were each eligible for the $250 deduction, for a total of $500 on the return. However, neither spouse could deduct more than $250 of his own expenses.

Eligible expenses included:
• Books.
• Supplies (other than nonathletic supplies for courses of instruction in health or physical education).
• Computer equipment (including related software and services).
• Other equipment and supplementary materials used by the educator in the classroom.

These expenses must be ordinary and necessary employee business expenses. An ordinary expense is one that is common and accepted in the educational field. A necessary expense is one that is helpful and appropriate for the profession of being an educator. An expense does not have to be required to be considered necessary.

Eligible expenses must be reduced by the following amounts:
• Excludable U.S. series EE and I savings bond interest from Form 8815.
• Nontaxable qualified tuition program earnings.
• Nontaxable earnings from Coverdell education savings accounts.
• Any reimbursements received for these expenses that were not reported in box 1 of the educator’s Form W-2.

An eligible educator was:
• Teacher, instructor, counselor, principal or aide and
• Who worked in a K–12 school (as determined under state law) for at least 900 hours during a school year. [IRC §62(d)(1)(A)]

Observation: The school year was used in determining if an individual meets the 900-hour requirement for defining an eligible educator, whereas the deduction was for expenses paid during the tax year. Because a school year spans two tax years, an individual who qualified as an eligible educator for either the 2010–2011 or 2011–2012 school year was eligible for the deduction for the 2011 tax year.

Form 1040 reporting. The educator’s expense deduction was claimed on line 23 of Form 1040. Itemizing deductions was not necessary to claim it.

If the ordinary and necessary educator expenses were over $250, the excess was deductible on Schedule A as a miscellaneous itemized deduction subject to the 2%-of-AGI floor. Complete Form 2106 for unreimbursed employee business expenses.

Example: Seth, age 25 and single, is a seventh-grade history teacher. During 2011, he incurred $300 for supplemental classroom materials and supplies that were not reimbursed by his employer. Seth deducted $250 on line 23 of his 2011 Form 1040. If Seth’s marginal federal rate was 15%, this saved $38; if his marginal federal rate was 25%, the savings were $63. The remaining $50 was deductible on Schedule A as a miscellaneous itemized deduction (subject to the 2%-of-AGI floor).

Personal Educational Expenses

It’s not uncommon for teachers to incur education expenses related to their job. Education expenses can be claimed, subject to certain limits and requirements, as either:
• Educator’s expense deduction (if extended).
• Education credit.
• Tuition and fees deduction.
• Unreimbursed employee business expense (Schedule A miscellaneous itemized deduction subject to the 2%-of-AGI floor).
• Schedule C deduction if self-employed.

Work-related education. An employee’s expenses for work-related education may be deductible, subject to the 2%-of-AGI floor. To be deductible, expenses must be incurred for qualifying education, defined as education that: [Reg. §1.162-5(a)]
1) Is required by an employer or the law to keep a present salary, status or job or
2) Maintains or improves skills required for present work.

All teaching and related duties are considered the same general kind of work. Thus, a change of duties in any of the following ways is not considered a change to a new business: [Reg. §1.162-5(b)(3)(i)]
1) Elementary school teacher to secondary school teacher.
2) Teacher of one subject, such as mathematics, to teacher of another subject, such as science.
3) Classroom teacher to guidance counselor.
4) Classroom teacher to principal.

Current employment required. A taxpayer must be currently employed or otherwise engaged in a trade, business or profession to deduct educational expenses as work-related expenses. However, a taxpayer who temporarily leaves his job to pursue full-time education (and then returns to his job) continues to qualify for the deduction.

• The IRS considers a suspension period of one year or less to be temporary. (Rev. Rul. 68-591)
• The Tax Court is generally more liberal. In one situation, the court ruled that a school principal who quit his job to enroll in a three-year PhD program (full-time) had only temporarily ceased employment, and thus his educational expenses were deductible. (Picknally, TC Memo 1977-321)

Example #1: Charles, a high school English teacher, is required by state law to take a certain number of college hours (equal to one class) each year to keep his teaching job. Therefore, he takes an English composition class in the spring semester of 2012.

Charles can deduct the cost of tuition, books and other related college fees associated with that course because the education is necessary for him to retain his teaching position. Alternately, Charles may be able to claim the Lifetime Learning credit for the education expenses.

Example #2: Phyllis is a high school history teacher. She takes a year leave of absence to obtain her master’s degree in school administration. Upon completion of her master’s program, she plans to return to her school as a vice principal. Although Phyllis is not required by either the law or her employer to get her master’s degree, her educational expenses are still deductible as work-related expenses because they meet the requirement of maintaining or improving her skills for her job and because she will be returning to work in education rather than starting a career in a new trade or business.