Section 2 Income and Assets

2.3 Property: Real and Personal
1. Sale or disposition of property

Sale or Disposition of Property

PROPERTY TRANSACTIONS: DETERMINATION OF GAIN OR LOSS AND BASIS CONSIDERATIONS

The following models provide an overview of property transactions.

Model for Gains

Amount realized

– Adjusted basis= Realized gain

– Postponed (deferred) gain

– Tax-free gain

= Recognized gain **(Capital Gain or Ordinary income)**

Sale or Disposition of Property

Model for Losses

Amount realized
– Adjusted basis
= Realized loss
– Postponed (deferred) loss
– Disallowed loss
= Recognized loss **(Capital Loss or Ordinary Loss)**

SALE OR EXCHANGE

Recognition. There must be a sale or exchange before a capital gain or loss is recognized.

a. "Sale" can include some unusual situations. For instance, when a taxpayer's home is repossessed by a mortgage lender, the tax law treats this as a sale. The fair market value of the residence will be at least equal to the debt which is cancelled as a result of the repossession.

"**Exchanges**" also come in many varieties. For instance, an involuntary conversion resulting from a condemnation can end up being an exchange if the condemnation occurs at a gain and the condemnation proceeds are reinvested.

DETERMINATION OF GAIN OR LOSS

Realization of Gain or Loss. Useful Purposes for Determining.

a. Realization normally is the ceiling on recognition.

b. The amount of realized gain or loss is required in order to calculate the amount of the postponed gain or loss associated with a nontaxable exchange.

(1) Such postponed gain or loss is required under one of the two basis calculation formulas in order to calculate the adjusted basis of the replacement property received in a nontaxable exchange.

Amount Realized

The amount realized is the sum of any money received plus the fair market value of other property received.

a. The amount realized includes any liability on the property disposed of if the buyer assumes the liability or the property is sold subject to the liability. The amount of such liability is included in the amount realized even if the debt is nonrecourse and the amount of the debt is greater than the fair market value of the mortgaged property.

b. The amount realized includes real property taxes under § 164(d) which are imposed on the seller, but are paid by the buyer.

c. The amount realized is reduced by selling expenses such as advertising, commissions, and legal fees associated with the sale or other disposition.

Adjusted Basis

The adjusted basis is the tax basis of the property at the date of disposition and is calculated as follows:

Original basis on date of acquisition (i.e., cost)

+ Capital additions

– Capital recoveries

= Adjusted basis on date of disposition

Adjusted Basis

a. The original basis of the property depends on how the property was acquired.

b. Capital additions include the cost of capital improvements and betterments made to the property by the taxpayer (i.e., capital expenditures).

c. Capital recoveries reduce the adjusted basis because the taxpayer has received a tax benefit. Examples are:

Classification as a Capital Asset

Classification is determined based on <u>three items</u>:

a. The <u>tax status</u> of the property (capital asset, § 1231 asset, or ordinary asset).
b. The <u>manner of</u> the property's <u>disposition</u> (sale, exchange, casualty, theft, or condemnation).
c. The <u>holding period</u> of the property (short-term or long-term).
d. Ordinary asset status is a "default" status if the asset is neither a capital asset nor a § 1231 asset.
e. The tax status of the asset is usually not particularly relevant until the asset is sold or its sale is being contemplated. Then, the tax status becomes important because the character of the gain or loss from the asset's disposition is affected by the asset's tax status. How and where the disposition is reported on the tax forms also is impacted by the asset's tax status.

Section 2: Income and Assets

2.3 Property: Real and Personal
2. Capital Gains and Losses
(Netting effect, short-term, long-term)

Capital Gains and Losses

- A Capital asset is: "Any asset other than inventory, receivables, copyrights, assets created by the taxpayer, and depreciable or real property used in a trade or business"

- A Collectible gain or loss results from the sale or exchange of works of art, gems, metals, antiques, rugs, stamps, wine, etc. held more than 12 months.

Capital Asset Definition

A capital asset is **NOT**:

- An Inventory item
- A Receivable
- Real or depreciable property used in a trade or business
- A Copyright, literary, musical, or artistic composition, etc., held by the person creating the property or held by a person who received the property as a gift from its creator
- Certain U.S. government publications

Capital Gains and Losses: Holding Period

The Holding period **for capital assets is how long the taxpayer owned the asset**.

- Long-term **means the asset was held for more than 12 months**
- Short-term means the asset was held for

  $\leq$ 12 months
- Determining holding period is the first step in determining tax treatment

Capital Gains and Losses: Netting Procedures

The following are treated as long-term gains and losses *for the netting procedure*

- Collectible gains and losses
- Gains on qualified small business stock
- Unrecaptured Section 1250 gain

Capital Gains and Losses: Netting Procedures

Long-term gains netted against Long-term losses = Net Long-term Gain or Loss

Short-term gains netted against Short-term losses = Net Short-term Gain or Loss

Capital Gains and Losses: Netting Procedures

If one is a loss and one is a gain, then:

Net Short-term Gain or Loss
netted against
Net Long-term Gain or Loss
=
Net Capital Gain or Loss

If both are losses or both are gains, no further netting is done.

Tax Treatment for Net Long-Term Gain Individual Taxpayers

Net long-term gain (minus net collectibles gain, gain on qualified small business stock, and unrecaptured Section 1250 gain)

taxed at a maximum rate of 15%

Exceptions: Capital gains rate =

0% if marginal tax rate ≤ 15%

20% if marginal rate = 39.6%

Tax Treatment for Net Long-Term Gain Individual Taxpayers

- Collectibles held more than 12 months are taxed at a maximum rate of 28%
- 50% of the gain on qualified small business stock is excluded, the remainder is taxed at a maximum rate of 28%
- Unrecaptured Section 1250 gain is taxed at a maximum rate of 25%

Adjusted Net Capital Gains (ANCG)

- Are taxed at the 20%, 15% or 0% rates
- ANCG = NLTG - [Net Collectible Gain + Small Business Gain - NSTCL - LTL carryovers]* - unrecaptured Sec. 1250 gain + Eligible Dividend Income

Tax Treatment for Net Long-Term Gain Individual Taxpayers Example

Juan has the following capital gains and losses in the current year:

Short-term capital loss	$(2,000)
Long-term capital gain	12,000
Long-term capital loss carryover	(5,000)
Collectibles gain	10,000

Tax Treatment for Net Long-Term Gain Individual Taxpayers: Example

Short-term:		
Short-term capital loss	$ (2,000)	
Long-term:		
Collectibles gain		$10,000
Long-term capital gain		12,000
Long-term capital loss c/o		(5,000)
Long-term capital gain	$ 17,000	
Net long-term capital gain	**$ 15,000**	

Tax Treatment for Net Long-Term Gain Individual Taxpayers: Example

Results:

"28% rate gain" = ($10,000 - $5,000 - $2,000)

= $3,000

ANCG = $15,000 - $3,000 = $12,000

NLTCG is added to taxable income

Net capital gain, taxed at 15% = $12,000

Collectibles gain, taxed at 28% = $3,000

Tax Treatment for Net Short-Term Gain

- Individual’s net stcg is taxed as ordinary income (i.e., at taxpayer’s marginal tax rate)

- Corporations do not receive special treatment for capital gains

Tax Treatment for Net Capital Loss

- Individuals may use only $3,000 to offset other income
  - Excess loss is carried forward indefinitely and retains its short term or long term class for netting purposes

- Corporations cannot deduct a net capital loss
  - Excess loss carried back 3 then forward 5 years to offset capital gains

Tax Treatment for Net Gains

- Net short-term capital gain is taxed as ordinary income
- Adjusted net long-term capital gain is taxed at 15% (20% if marginal rate is 36.9%; 0% if marginal rate 0 or 15%)
  - Adjusted NLTG = NLTG - [28% rate gain - Unrecaptured §1250 gain + Eligible dividends]
  - 28% rate gain = [Net collectibles gain + Small business stock gain - STCL - LTCL carryover]

Section 2: Income and Assets

2.3 Property: Real and Personal

3. Basis of Assets (Purchased, gifted or inherited)

Basis of Assets (purchased, gifted or inherited)

Basis of Property is Generally Cost. Cost is the amount paid for the property in cash or other property.

Purchased Property

- Basis of property acquired by purchase usually follows the general rule that its basis is cost.
- Bargain purchases are an exception. Basis of property acquired in a bargain purchase is its fair market value.

(1) The reason for this exception is that the taxpayer includes the difference between his or her cost and the fair market value of the property in gross income.

(2) To preclude the previously taxed income from being taxed again, the difference is included in the taxpayer's basis

Gifted Property

Reason for Carryover Basis. A taxpayer who receives property as a gift has no donee cost or consideration associated with the property.

a. Under § 102, gifts are not treated as gross income to the donee.

b. Therefore, a carryover basis must be assigned to the property.

(1) Otherwise, the amount of the gift would be taxed as a gain on the subsequent disposition of the property since the basis would be zero.

(2) In addition, there would be no basis for depreciation (cost recovery) if the gift property is depreciable.

Calculation of Basis of Gift Property

Basis of gift property depends on whether the donee recognizes a gain or a loss on the subsequent disposition of the property.

a. Gain basis: If the subsequent disposition results in a gain, the basis of the gift property is the same as the donor's adjusted basis on the date of the gift if no gift tax is paid. If gift tax is paid, the basis calculation formula is dependent on whether the gift was made prior to 1977 or after 1976.

Inherited Property

Reason for Fair Market Value Basis. A taxpayer who inherits property has no cost basis for the property.

a. Under § 102, inherited property is not treated as gross income to the beneficiary. Therefore, a basis must be assigned.

(1) Otherwise, the amount of the inheritance would be taxed as gain on the subsequent disposition of the property since the basis would be zero.

(2) In addition, there would be no basis for depreciation (cost recovery) if the inherited property is depreciable.

Calculation of Basis of Gift Property

(1) Gifts made prior to 1977: The calculation formula is as follows:

Donor's basis + gift tax paid*

*Gift tax paid is permitted to be added only to the extent the summation of the donor's basis and gift tax paid does not exceed the fair market value of the property at the date of the gift.

(2) Gifts made after 1976: The calculation formula is as follows:

$$\text{Donor's basis} + \left(\frac{\text{Unrealized appreciation}}{\text{Taxable gift*}}\right) \text{X Gift tax paid}$$

*The taxable gift is the fair market value of the gift less the per donee annual exclusion of $13,000.

Calculation of Basis

The basis of property acquired from a decedent is usually its fair market value on the date of the decedent's death.

Alternate Basis. If the alternate valuation date and basis are available, the basis of the inherited property to the beneficiary is the fair market value six months after the date of death.

A. To be eligible for this option, it must be necessary to file an estate tax return (i.e., the value of the estate must exceed a specified amount).

B. The alternate valuation date and amount are available only if elected by the executor of the estate. The election cannot be made on a property by property basis, but must be made for all the property in the estate.

Basis of Inherited Property

Section 2032(c) provides that the alternate valuation date can be elected only if the election results in both (1) the value of the gross estate and (2) the estate tax liability being reduced below the amount they would have been if the primary valuation date had been used.

Special Limitation on "Death-Bed" Gifts. Section 1014 contains a provision intended to eliminate a tax avoidance scheme associated with "death-bed" gifts.

a. If (1) the decedent received appreciated property as a gift during the one-year period ending on the date of the decedent's death, and (2) the property is acquired from the decedent by the donor of the property (or the donor's spouse), the property will have a carryover basis rather than a stepped-up basis.

b. $11,000. However, because the one-year exception applies, his basis is $6,000 (i.e., the same as the decedent's basis). If Doris had made a capital improvement to the property of $2,000 after its receipt by gift and prior to her death, Steve's basis would be $8,000 ($6,000 + $2,000).

Basis of Inherited Property

Effect of Community Property Statutes. For jointly-held property of spouses (i.e., tenants by the entirety or joint tenants with rights of survivorship), the basis of the property to the surviving spouse is dependent on whether community property law or common law is applicable.

a. In a community property state, both the decedent's share and the survivor's share will have a basis equal to fair market value on the date of the decedent's death.

b. In a common law state, only the share received from the decedent will have a basis equal to fair market value (i.e., the survivor's share will retain its adjusted basis).

Holding Period. The holding period of inherited property automatically is long-term.

Section 2: Income and Assets

4. Basis of stock after stock splits and/or stock dividends (e.g., research, schedules, brokerage records)

A stock split occurs when a company creates additional shares, thus reducing the price per share. If you own stock that has split and now own additional shares, you must adjust your basis per share or per the lots of the stock you own. If you purchased the old shares in separate lots for differing amounts of money (a different basis per share in different lots):

Basis of stock after stock splits and/or stock dividends (e.g., research, schedules, brokerage records)

Allocate the adjusted basis of the old stock between the old and new stock on a lot by lot basis. Example: Suppose you have 200 shares of XYZ Inc. common stock. You initially bought 100 shares at $10 per share. You later bought another 100 shares at $12 per share. XYZ Inc. announces a two for one stock split and issues you 200 additional shares. You update your records. The first lot of 100 shares is now 200 shares. Your total basis in the 200 new shares is the same $1,000 basis you had in the 100 shares before the split. The new per share basis is $5 ($1,000/200 = $5). Similarly, your second lot of 100 shares is now 200 shares. Your total basis in these 200 new shares is $1,200, the same as your basis in the 100 shares before the split. The new per share basis is $6 ($1,200/200 = $6).

Basis of stock after stock splits and/or stock dividends (e.g., research, schedules, brokerage records)

Allocation for Stock Rights and Stock Dividends. Allocation may be necessary on the receipt of nontaxable stock dividends and stock rights under §§ 305(a) and 307(a).

a. Nontaxable stock dividends. The allocation depends on whether the dividend is a common stock dividend on common stock or a preferred stock dividend on common stock. The holding period for a nontaxable stock dividend, whether received in the form of common stock or preferred stock, includes the holding period of the original shares.

(1) Common stock dividend on common stock. In this case, the cost of the original common shares is allocated to the total shares owned after the dividend.

(2) Preferred stock dividend on common stock. In this case, the cost of the original common shares is allocated between the common and preferred shares on the basis of their relative fair market values on the date of distribution.

Basis of stock after stock splits and/or stock dividends
(e.g., research, schedules, brokerage records)

Nontaxable stock rights. Whether part of the basis of the stock is allocated to the stock rights depends on the relative values of the stock and the rights or on whether the taxpayer elects to allocate. The holding period of nontaxable stock rights includes the holding period of the stock on which the rights were distributed. However, if the rights are exercised, the holding period of the newly acquired stock begins with the date the rights are exercised.

(1) Fair market value of the stock rights is at least 15% of the fair market of the stock. Allocation is mandatory in this case.

(2) Fair market value of the stock rights is less than 15% of the fair market value of the stock. Allocation is not required in this case. However, the taxpayer can elect to allocate.

Section 2: Income and Assets

6. Sale of Personal Residence (e.g., Sec 121 Exclusions)

Sale of Personal Residence (Sec 121 Exclusions)

Purchase of a replacement residence is not required. To be eligible for the § 121 exclusion, there is no need to acquire another residence.

Basis of a new residence is its cost.

Requirement That Property Be Taxpayer's Principal Residence. The property sold must have been the taxpayer's principal residence.

a. Whether the property is the principal residence is dependent on the facts and circumstances.

b. Generally, the principal residence is the one in which the taxpayer resides most of the time.

SALE OF A RESIDENCE (§ 121 EXCLUSION): REQUIREMENTS FOR EXCLUSION TREATMENT

Principal Residence. The property must have been the taxpayer's principal residence.

Ownership and Occupancy Requirements. At the date of sale, the residence must have been owned and used by the taxpayer as the principal residence for at least two years during the 5-year period ending on the date of the sale.

Frequency of use of §121.

(1) The § 121 exclusion can be used only once every 2 years (i.e., not permitted for sales occurring within 2 years of its last use).

SALE OF A RESIDENCE: CALCUATION OF THE AMOUNT OF THE EXCLUSION

Maximum amount of § 121 exclusion for an unmarried individual is $250,000.

a. If realized gain is not greater than $250,000, the recognized gain is $0.

b. If realized gain is greater than $250,000, the recognized gain is the excess of the realized gain over $250,000.

c. Amount realized in calculating the realized gain is the selling price less the selling expenses.

Examples of selling expenses: includes items such as cost of advertising the residence for sale, real estate broker commissions, legal fees in connection with the sale, and loan placement fees paid by the seller as a condition of arranging financing for the buyer.

Repairs and maintenance made by the seller to aid in selling the property are neither selling expenses nor adjustments to the seller's basis for the residence.

Maximum amount of § 121 exclusion for a married couple

If a married couple <u>files a joint return</u>, the <u>$250,000</u> § 121 exclusion <u>amount</u> is <u>increased to $500,000</u> if the <u>following requirements</u> are <u>satisfied</u>.

(1) <u>Either spouse</u> meets the at-least two years <u>ownership requirement</u>.

(2) <u>Both spouses</u> meet the at-least two years <u>use requirement</u>.

<u>Neither spouse</u> is <u>ineligible</u> for the § 121 exclusion on the sale of the current principal residence <u>because of the sale of another principal residence within the prior two years</u>.

b. If <u>each spouse owns a qualified principal residence</u>, <u>each can qualify</u> for the maximum <u>$250,000 exclusion</u> on the <u>sale of their own residence</u> <u>regardless</u> of whether a <u>joint return</u> or <u>separate returns are filed</u>.

Section 2 Income and Assets

7. Installment sales (e.g., related parties, original cost, date of acquisition, possible recalculations and recharacterization)

- Related Parties
- Original Cost
- Date of Acquisition
- Possible Recalculations and recharacterization

Installment sales

An installment sale is a sale of property where you will receive at least one payment after the tax year in which the sale occurs. You are required to report gain on an installment sale under the installment method unless you "elect out" on or before the due date for filing your tax return (including extensions) for the year of the sale. You may elect out by reporting all the gain as income in the year of the sale on Form 4797 , *Sales of Business Property*, or on Form 1040, Schedule D , *Capital Gains and Losses*, and Form 8949 , *Sales and Other Dispositions of Capital Assets*. Installment method rules do not apply to sales that result in a loss. You cannot use the installment method to report gain from the sale of inventory or stocks and securities traded on an established securities market. You must report any portion of the gain from the sale of depreciable assets that is ordinary income under the depreciation recapture rules in the year of the sale.

Sales between related parties

Sales of depreciable assets between related parties can cause the total gain to be recognized as ordinary income

- Applies to related party sales or exchanges of property that is depreciable in hands of transferee

Related Effects of Recapture
Installment sales

Recapture gain is recognized in year of sale regardless of whether gain is otherwise recognized under the installment method

Depreciation Recapture and Installment Sales

Assume Hazel could sell the used equipment for $28,000 down and the $100,000 balance in five yearly installments of $20,000 plus interest.

She would have to recognize her entire $53,040 gain ($128,000 sale price - $74,960 adjusted basis) in 2015.

All of the gain is § 1245 depreciation recapture gain because the $375,040 depreciation taken exceeds the $53,040 recognized gain.

Section 2: Income and Assets

8. Options (e.g., Stock, Commodity, ISO, ESPP)

Sale or Exchange–Options (slide 1 of 2)

For the grantee of the option, if the property subject to the option is (or would be) a capital asset in the hands of the grantee

- Sale of an option results in capital gain or loss
- Lapse of an option is considered a sale or exchange resulting in a capital loss

For the grantor of an option, the lapse creates

- Short-term capital gain, if the option was on stocks, securities, commodities or commodity futures
- Otherwise, ordinary income

Sale or Exchange–Options (slide 2 of 2)

Exercise of an option by a grantee

- Increases the gain (or reduces the loss) to the grantor from the sale of the property
- Gain is ordinary or capital depending on the tax status of the property

Grantee adds the cost of the option to the basis of the property acquired

Options Example Slide 1

On February 1, 2015, Mary purchases 100 shares of Aston Company stock for $5,000.

- On April 1, 2015, he writes a call option on the stock, giving the grantee the right to buy the stock for $6,000 during the following six-month period.
- Maurice (the grantor) receives a call premium of $500 for writing the call.

Options Example Slide 2

If the call is exercised by the grantee on August 1, 2015, Mary has $1,500 of short-term capital gain from the sale of the stock.

- $6,000 + $500 − $5,000 = $1,500

The grantee has a $6,500 basis for the stock.

- $500 option premium + $6,000 purchase price

Options Example Slide 3

Assume that Mary decides to sell his stock prior to exercise for $6,000 and enters into a closing transaction by purchasing a call on 100 shares of Aston Company stock for $5,000.

- Because the Aston stock is selling for $6,000, Mary must pay a call premium of $1,000.

She recognizes a $500 short-term capital loss on the closing transaction.

- $1,000 (call premium paid) − $500 (call premium received)

On the actual sale of the Aston stock, Mary has a short-term capital gain of $1,000

- $6,000 (selling price) − $5,000 (cost)

Options Example Slide 4

Assume that the original option expired unexercised.

Mary has a $500 short-term capital gain equal to the call premium received for writing the option.

- This gain is not recognized until the option expires.

The grantee has a loss from expiration of the option.

- The nature of the loss will depend upon whether the option was a capital asset or an ordinary asset.

Section 2 Income and Assets

9. Like-kind exchange

Like-kind exchange

Property exchanged must be like-kind property.

Under Reg. § 1.1031(a)-1(b), “the words ‘like-kind’ have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class b.

The intent is that the term be interpreted broadly. However, there are three categories of exchanges which never qualify. These are:

(1) The exchange of real property (realty) for personal property (personalty) and vice-versa.

(2) The exchange of livestock of different sexes.

(3) The exchange of real property located in the United States for foreign real property and vice-versa.

Like-Kind Property and Nontaxable Exchanges

A nontaxable exchange is a transaction in which the realized gain or loss is NOT currently recognized.

a. If the exchange is completely nontaxable, all of the realized gain or loss is postponed.

b. If the exchange is partially nontaxable, only part of the realized gain or loss is postponed.

c. Potential forms of the transaction are sales, exchanges, and involuntary conversions (i.e., casualty, theft, or condemnation).

Elective or Mandatory Nature of Nontaxable Exchange. The ability to postpone recognition of the realized gain or loss is either mandatory or elective.

Which of the two that applies depends on the statutory language.

Like-kind exchange

Even if the property exchanged qualifies as like-kind property, § 1031 postponement may not apply if the taxpayers involved in the exchange are related parties.

(1) To qualify for postponement treatment, the taxpayer and the related party must not dispose of the like-kind property received in the exchange within the two-year period following the date of the exchange.

(2) An early disposition results in the realized gain being recognized as of the date of such early disposition.

Certain events are not treated as early dispositions: transfers due to death, involuntary conversions, and certain non-tax avoidance transactions.

Section 2: Income and Assets

10. Non-Business Bad Debts
(e.g., documentation requirements)

Non-Business Bad Debts (Documentation Required)

Nonbusiness Bad Debts. A nonbusiness bad debt is a short-term capital loss.

a. The debt must be completely worthless before the loss is deductible.

b. The debt is short-term regardless of how long the debt has been held.

Section 2: Income and Assets

2.4 Adjustments to Income

1 Self-Employment

2 Retirement Contribution Limits

3 Health Saving Accounts Deductibility

4 Other Adjustments Income

5. Self- Employment Health Insurance

Deductions—Individual Taxpayers

Individual taxpayers have two categories of deductions:

- **Deductions *for* adjusted gross income (AGI)**
- Deductions *from* adjusted gross income

Deductions for adjusted gross income (AGI

- Sometimes known as above-the-line deductions
- On the tax return, they are taken before the “line” designating AGI

Deductions for adjusted gross income (AGI

Deductions *for* AGI include:

- Ordinary and necessary expenses incurred in a trade or business
- Part of self-employment tax paid
- Alimony paid
- Certain payments to an IRA and Health Savings Accounts
- Unreimbursed moving expenses
- Fees for college tuition and related expenses
- Interest on student loans
- The capital loss deduction, and
- Others

Coverdell Education Savings Account (CESA)

This is a trust for the benefit of anyone under age 18

- $2,000 nondeductible contribution per student per year
  - Phased-out for AGI greater than
    - $190,000 (mfj); $95,000 (others)
    - Max. contribution = $2,000 x [1 - (AGI - phase-out) / 15,000]
    - Tax-free growth in the IRA
- There is no tax at time of withdrawal if used for qualified expenses
  - Tuition and fees of student

1. Self-employment Income Tax

Who is Self-Employed?

Generally, you are self-employed if any of the following apply to you.

- You carry on a trade or business as a sole proprietor or an independent contractor.
- You are a member of a partnership that carries on a trade or business.
- You are otherwise in business for yourself (including a part-time business)

What are My Self-Employed Tax Obligations?

As a self-employed individual, generally you are required to file an annual return and pay estimated tax quarterly.

Self-employed individuals generally must pay self-employment tax (SE tax) as well as income tax. SE tax is a Social Security and Medicare tax primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners. In general, anytime the wording "self-employment tax" is used, it only refers to Social Security and Medicare taxes and not any other tax (like income tax).

2. Retirement Contribution Limits and Deductibility (Earned Compensation Requirement)

For 2018 and 2019, your total contributions to all of your traditional and Roth IRAs cannot be more than:

- $6,500 (if you're age 50 or older), or
- your taxable compensation for the year, if your compensation was less than this dollar limit.
- The IRA contribution limit does not apply to:
- Rollover contributions
- Qualified reservist repayments

Claiming a tax deduction for your IRA contribution

Your traditional IRA contributions may be tax-deductible. The deduction may be limited if you or your spouse is covered by a retirement plan at work and your income exceeds certain levels.

- IRA deduction limits
- **Roth IRA contribution limit**
- The same general contribution limit applies to both Roth and traditional IRAs. However, your Roth IRA contribution might be limited based on your filing status and income.

IRA contributions after age 70½

You can't make regular contributions to a traditional IRA in the year you reach 70½ and older. However, you can still contribute to a Roth IRA and make rollover contributions to a Roth or traditional IRA regardless of your age.

Spousal IRAs

If you file a joint return, you may be able to contribute to an IRA even if you did not have taxable compensation as long as your spouse did. The amount of your combined contributions can't be more than the taxable compensation reported on your joint return. See the formula in IRS Publication 590-A.

If neither spouse participated in a retirement plan at work, all of your contributions will be deductible.

Tax on excess IRA contributions

An excess IRA contribution occurs if you:

- Contribute more than the contribution limit.
- Make a regular IRA contribution to a traditional IRA at age 70½ or older.
- Make an improper rollover contribution to an IRA.

Excess contributions are taxed at 6% per year as long as the excess amounts remain in the IRA. The tax can't be more than 6% of the combined value of all your IRAs as of the end of the tax year. To avoid the excess contributions tax: withdraw the excess contributions from your IRA by the due date of your individual income tax return (including extensions); and withdraw any income earned on the excess contribution.

3. Health Savings Account

A health savings account is a tax-exempt trust or custodial account you set up with a qualified HSA trustee to pay or reimburse certain medical expenses you incur. You must be an eligible individual to qualify for an HSA.

No permission or authorization from the IRS is necessary to establish an HSA. You set up an HSA with a trustee. A qualified HSA trustee can be a bank, an insurance company, or anyone already approved by the IRS to be a trustee of individual retirement arrangements (IRAs) or Archer MSAs. The HSA can be established through a trustee that is different from your health plan provider.

What are the benefits of an HSA?

You may enjoy several benefits from having an HSA.

You can claim a tax deduction for contributions you, or someone other than your employer, make to your HSA even if you do not itemize your deductions on Form 1040.

Contributions to your HSA made by your employer (including contributions made through a cafeteria plan) may be excluded from your gross income.

The contributions remain in your account until you use them.

The interest or other earnings on the assets in the account are tax free.

Distributions may be tax free if you pay qualified medical expenses.. An HSA is "portable." It stays with you if you change employers or leave the work force.

Qualifying for an HSA

To be an eligible individual and qualify for an HSA, you must meet the following requirements.

- You must be covered under a high deductible health plan (HDHP), described later, on the first day of the month.
- You have no other health coverage except what is permitted under Other health coverage.
- You are not enrolled in Medicare.
- You cannot be claimed as a dependent on someone else's 2014 tax return.

4. Other adjustments to income (e.g., student loan interest, alimony, moving expenses, write-in adjustments)

- Student Loan Interest
- Alimony
- Moving Expense

Deduction for Higher Education Expenses

For AGI deductions:

- Maximum deduction of $4,000 for tuition and fees paid
- For taxpayers with AGI>$130,000 MFJ, $65,000 all others
- Reduced to $2,000 for taxpayers with AGI between $130,000 and $160,000 MFJ, or $65,000 and $80,000 for all others
- Cannot take this deduction and claim an American Opportunity Tax credit or Lifetime Learning credit
- May receive a distribution from an educational IRA but not for the same expenses.

Education Loan Interest

You may deduct up to $2,500 for interest paid on education loans

- Taken as a “for” deduction
- Only for payments made during first 60 months of the loan
- Deduction phased-out when AGI exceeds
  - Married, $120,000; Others, $60,000
  - Deduction =

  Amt. Allowed x [1 - {(AGI - phase-out) / 15,000}]

Alimony

Amounts paid under divorce or separate maintenance decrees or written separation agreements entered into between you and your spouse or former spouse **are considered alimony** for federal tax purposes if:

- You and your spouse or former spouse do not file a joint return with each other
- You pay in cash (including checks or money orders)
- The payment is received by (or on behalf of) your spouse or former spouse
- The divorce or separate maintenance decree or written separation agreement does not say the payment is not alimony
- If legally separated under a decree of divorce or separate maintenance, you and your former spouse are not members of the same household when you make the payment
- You have no liability to make the payment (in cash or property) after the death of your spouse or former spouse, and
- Your payment is not treated as child support or a property settlement

Alimony

- Not all payments under a divorce or separation instrument are alimony. Alimony **does not** include:
- Child support
- Noncash property settlements
- Payments that are your spouse's part of community property income
- Payments to keep up the payer's property, or
- Use of the payer's property
- Voluntary payments
- You may deduct from income the amount of alimony or separate maintenance you paid, and you must include in income the amount of alimony or separate maintenance you received.

Moving Expenses

Moving expenses are deductible if they meet two tests:

- Distance test
- Time test
  - Employee taxpayers must be employed in the new area for 39 weeks of the 12 months after moving *Self-employed taxpayers must be employed in the* new area for 78 weeks of the 24 months after moving
  - Waived for death, disability, or required transfer

Moving Expenses

If you moved due to a change in your job or business location, or because you started a new job or business, you may be able to deduct your reasonable moving expenses but not any expenses for meals. You can deduct your moving expenses if you meet all three of the following requirements:

- Your move closely relates to the start of work
- You meet the distance test
- You meet the time test

Your move must **closely relate** both in time and in place **to the start of work** at your new location. You can consider moving expenses incurred within one year from the date you first reported to work at the new location as closely related in time to the start of work. A move generally relates closely in place if the distance from your new home to the new job location is not more than the distance from your former home to the new job location. For exceptions to these requirements, see Publication 521, *Moving Expenses*.

Moving Expenses

If you are a member of the Armed Forces and your move was due to a military order and permanent change of station, you do not have to satisfy the distance or time tests.

Return. You cannot deduct any moving expenses covered by reimbursements from your employer that are excluded from your income.

Section 3: Deductions and Credits
3.1 Itemized Deductions

1. Medical and Dental Expenses
2. Various taxes (e.g., state income, personal property, real estate)
3. Interest expense (e.g., mortgage interest, investment interest, tracing rules, points)
4. Charitable Contributions

Part 1 Itemized Deductions

5. Non business Casualty and Theft Losses
6. Miscellaneous Itemized Deductions
7. Employee Travel, Transportation and Entertainment Expenses
8. Other Employee Expenses
9. AGI Limitations
10. Allowed Itemized Deductions for Form 1040-NR

Deductions from AGI

Individual taxpayers may deduct the larger of either:

A standard deduction

or

Total itemized deductions

Deductions From AGI

The standard deduction is the sum of two components:

- *Basic* standard deduction- The mount allowed is based on taxpayer's filing status
- Additional standard deductions- Available for taxpayers who are
    - Age 65 or over, and/or Blind
  - Two additional standard deductions are allowed for a taxpayer who is age 65 or over and blind
  - Amount allowed depends on filing status

Standard Deductions

Is Based on filing status

- Taxpayers who are over 64 years of age receive extra amounts, as do blind taxpayers

Standard deduction amounts:

	2018	**2019**
Single	$12,000	$12,200
Married, filing jointly	$24,000	$24,400
Married, filing separately	$12,000	$12,200
Head of Household	$18,000	$18,350
Surviving spouse	$24,000	$24,400

Itemized Deductions

Through legislative grace, there are 6 categories of personal expenses individual taxpayers may deduct:

- Medical
- Taxes
- Interest
- Charitable Contributions
- Casualty Losses
- Miscellaneous

Adjusted Gross Income (AGI)

AGI is an important subtotal

- Serves as the basis for computing percentage limitations on certain itemized deductions such as
  - Medical expenses
  - Charitable contributions
  - Certain casualty losses
- E.g., For taxpayers under age 65, medical expenses are deductible only to the extent they exceed 10% of AGI
  - This limitation might be described as a 10% “floor” under the medical expense deduction

Deductions From AGI

Deductions *from* AGI include:

The greater of:

- Itemized deductions, or
- The standard deduction

And

- Personal and dependency exemptions

Deductions From AGI

This is a partial list of itemized deductions:

- Medical expenses in excess of 10% of AGI
- Certain taxes and interest
- Charitable contributions
- Casualty Losses in excess of 10% of AGI
- Deductions for expenses related to
  - The production or collection of income, and
  - The management of property held for the production of income
  - Certain miscellaneous itemized deductions in excess of 2% of AGI

1. Medical and Dental Expenses

- Unreimbursed medical expenses of the taxpayer and medical dependents are deductible
  - Medical dependents need not meet the gross income and the joint return tests
  - Costs include premiums for health and accident insurance and transportation at 19 cents per mile
  - Deduction is limited to the excess of total costs over 10% of AGI (7.5% for taxpayers 65 and older through 2016)

2. Taxes

The Following payments are deductible:

- Amounts paid for either sales taxes **<u>or</u>** state and local income taxes are deductible
- Amounts paid for real estate and other personal property taxes are deductible
  - No payments for federal taxes are allowed
  - Property taxes must be based on value

3. Qualified Mortgage Interest

- Qualified home mortgage interest is deductible
  - Debt must be secured by a principal residence
  - *Qualified* interest is interest paid for Home owners. Taxpayers can deduct interest expenses on up to:
  - $750,000 of mortgage debt for couples Married Filing Joint
  - $375,000 for taxpayers Filing Separate from income taxes.
  - However, taxpayers will forego the standard deduction.
  - Home must have been purchased after December 15, 2017

3. Qualified Mortgage Interest – Points

Points on a qualified mortgage are deductible if paid to acquire financing:

- Must be stated as a % of the loan value
- Deductible currently if paid on acquisition debt
  - If for refinancing, amortize over the life of the loan

1.3 Investment Interest

- Deduction for investment interest is limited to the amount of *net investment income*
- Investment Income – Investment Expenses = Net Investment Income
  - Investment income = portfolio income plus gross income and gains from investment assets
  - Investment expenses include all ordinary and necessary expenses directly connected to the production of the investment income other than tax-exempt investment income.

1.4 Charitable Contributions

Deduction amount for property depends on the type of property given:

Ordinary income property or short-term capital gain property

- Deduction is the lesser of the property's
  - FMV, or
  - adjusted basis
- Deduction amount for long-term capital gain property is FMV

1.4 Charitable Contributions

Limitations

- Overall deduction cannot exceed 60% of AGI
- Deduction for long-term capital gain property cannot exceed 30% of AGI
  - If the taxpayer elects to deduct the adjusted basis rather than FMV, the 60% limit is used
- Contributions to non-operating private foundations are subject to additional limits

1.5 Casualty Losses

- Loss is the lesser of
  - Property's adjusted basis, or
  - Decline in the value of the property (repair cost)
- Loss is reduced by
  - Insurance proceeds received,
  - $100 per event (Administrative convenience), and
  - 10% of AGI per year

1.6 Miscellaneous Deductions

Various other expenses are combined as miscellaneous itemized deductions and are either fully deductible or partially deductible

1.6 Miscellaneous Deductions

Partially deductible (to the extent the total of this group of expenses exceeds 2% of AGI):

- Unreimbursed employee expenses
- Investment expenses other than interest
- Hobby-related expenses

1.6 Miscellaneous Deductions Fully Deductible

- Fully Deductible:
  - Gambling losses to the extent of gambling winnings,
  - Impairment-related-work expenses of disabled taxpayers, and
  - Unrecovered capital from a terminated annuity

Phase-out of Itemized Deductions and Exemptions

- High-income taxpayers must reduce their allowable itemized deductions and exemptions if their AGI is above a threshold amount
  - Threshold amounts are based on filing status and are the same for both itemized deductions and exemptions

Phase-out of Itemized Deductions

Taxpayers re subject to a limit on itemized deductions if the AGI is more than:

- $ 313,000 Married Filing Joint or Qualifying Widow (er)
- $ 287,550 Head of Household
- $ 261, 500 Single,
- $156,900 Married Filing Separately