



NEW JERSEY WORKING TOGETHER

EXAM PANEL AUDIT TECHNIQUE GUIDES



ATGs

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ATGs

What are the ATGs?

Previously name – MSSP

Market Segment Specialization Programs

Why were they developed?

How they can be used:

Audit

Collections

Appeals



Presentations

Ed Portice

Real Estate and Gambling

Hilly Kaufer

Trucking and Clergy

Len Steinberg

Military and Pilot and Flight Crews



GAMBLING

- The activity of gambling has drawn increasing attention from the IRS over the past few years due to the proliferation of online gambling in various forms. Before discussing the rules that affect taxpayers, let us first review some key terms.



GAMBLING

- **Background: What is Gambling?**
- Wagering winnings
- Lottery and raffle winnings
- NOT prizes from drawings, quiz shows, and contests
- Generally any expenses associated with such non-gambling winnings are not deductible.



GAMBLING

- A transaction is a wager if there is:
- a prize,
- a chance, and
- a consideration.



GAMBLING

- Winnings from a sweepstakes are not gambling the sweepstakes did not require a purchase to enter (no consideration)
- Winnings cannot be used to offset losses.
- SAE not consideration



GAMBLING

- Profit motive in each wagering transaction.
- A person who bets primarily for recreational purposes rather than business or profit purposes may deduct wagering losses to the extent of wagering gains.
- The wagering loss provisions are similar to the hobby loss rules.



GAMBLING

- **Internet Gambling and Legality**
- In November 2002 (in *Re: MasterCard*) the US Court of Appeals for the Fifth Circuit ruled that the Federal Wire Act prohibits electronic transmission of information for sports betting across telecommunications lines.



GAMBLING

- Court affirmed a lower court ruling that the Wire Act "'in plain language' does not prohibit Internet gambling on a game of chance."
- In 2011 the DOJ reversed its long-standing position, and issued a ruling that essentially concurred with this decision
- Allowed states to begin to allow internet based gambling.



GAMBLING

- As of December 2016, three states allow internet based gambling, Delaware, New Jersey, and Nevada (restricted to poker only in NV). For this reason, many internet gamblers use online casinos based in various foreign countries.



GAMBLING

- The Unlawful Internet Gambling Enforcement Act (UIGEA) was passed by Congress as part of the Safe Ports Act in 2006. Regulations that were promulgated under the UIGEA went into effect on June 1, 2010. The UIGEA did not outlaw online gambling, per se.



GAMBLING

- Law made it a violation of law for financial institutions to knowingly accept transactions to fund internet gambling.
- The UIGEA specifically exempts withdrawals from internet gambling sites.
- 2011 Justice Department ruling effectively removed the roadblocks set up by UIGEA.



GAMBLING

- The Treasury Department has generally considered online gambling accounts to be foreign financial accounts that must be reported.
- Schedule B, Part III where the “Yes” box on Line 7a must be checked and the name(s) of the country or countries listed on Line 7b.
- Schedule B must be filed even if there is no reportable interest or dividends.

GAMBLING

Figure 1 - Schedule B Foreign Account Reporting

You must complete this part if you (a) had over \$1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.		Yes	No
Part III Foreign Accounts and Trusts (See instructions on back.)	7a At any time during 2016, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
	If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements		
	b If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ► 		
	8 During 2016, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 17146N

Schedule B (Form 1040A or 1040) 2016



GAMBLING

- Schedule B, the online gambling taxpayer must complete and file FinCEN Form 114 (a.k.a. FBAR) if the combined value of all foreign financial accounts was in excess of \$10,000 at any time during the tax year.
- This form is not filed with the tax return. It must be electronically submitted by April 15 (or October 15) of the succeeding year.
- <http://bsaefiling.fincen.treas.gov/main.html>



GAMBLING

- 2016 ruling from the Ninth Circuit of the US Court of Appeals held that a taxpayer's two website gambling accounts with *PokerStars* and *PartyPoker* were not foreign financial accounts subject to FBAR reporting because they did not fall within the definition of a bank, securities, or other financial account. Those sites facilitate online gambling for taxpayers and do not serve any other financial purpose.



GAMBLING

- The legality of online gambling not considered since illegal income is just as taxable as legal income. Taxpayers engaging in this activity where funds are transferred from internet gambling accounts to domestic bank accounts need to be especially aware of the bank deposit analysis and economic reality audit techniques that can be applied by the IRS.



GAMBLING

- Professional gambler status has been growing dramatically in recent years due to the surge of online gambling.
- The proliferation of internet gambling is therefore generating examination activity that is unfamiliar to IRS examiners as well as tax professionals.



GAMBLING

- Professional gamblers can deduct their expenses on Schedule C
- The IRS position - Cannot be a professional gambler if they have another full-time job or business activity, i.e. filing two Schedule Cs or receive W-2 wages.



GAMBLING

- With internet gambling, it may be easier to show that the gambling is carried out with continuity and regularity but the taxpayer must still show the intent of earning their living from the activity.



GAMBLING

- All wagering income is includable in gross income
- Wagering losses are deductible to the extent of wagering gains
- Beyond a single gambling session the losses may not be netted against the gains, i.e. wagering income is first reported and wagering losses that do not exceed the income are then separately deducted.



GAMBLING

- Recreational gambler, the income is reported on Form 1040, Line 21, as “other income,”
- Losses up to but not exceeding the income are reported as a below-the-line deduction on Schedule A, Line 28 not subject to the 2% limitation.
- Effect on AGI and other deductions



GAMBLING

- If the taxpayer does not have enough itemized deductions including the wagering losses to exceed the standard deduction, they do not get any benefit from the wagering losses.



GAMBLING

- **Example:** Every Saturday in 2016, recreational gambler Frank purchases \$20 worth of lottery tickets. In July, he wins \$800 on one of his lottery tickets. Assume these are his only winnings all year from the lottery tickets. Frank is single and does not own a home. His only itemized deductions would be \$3,800 in state income tax withheld during the year.



GAMBLING

- Frank's \$800 winnings are reported as \$780 (\$800 less the \$20 he spent on tickets that week [one session]) on Form 1040, Line 21 and add to his AGI and taxable income. Although his total losses are \$1,020 (\$20 x the 51 weeks without winning), his itemized deductions are \$4,580 (\$3,800 state income tax + \$780 allowed of his gambling losses), and do not exceed his standard deduction of \$6,300, so his gambling losses are lost.



GAMBLING

- In the case of a joint return, the combined losses of the spouses from wagering transactions is allowed as a deduction on the joint return to the extent of the combined gains of the spouses from wagering transactions.



GAMBLING

- **Form W-2G** – issued by casino, racetrack or other venue
- Federal income tax that may have been withheld on those winnings.
- Bingo winnings or slot machine (not reduced by the wager) are \$1,200 +
- Keno game (reduced by the wager) are \$1,500 +



GAMBLING

- Poker tournament (reduced by the wager or buy-in) exceed \$5,000,
- Winnings:
 - \$600 or above, and
 - At least 300 times the amount of the taxpayer's wager, or
 - Subject to either regular gambling withholding or backup withholding of federal income tax.



GAMBLING

- If gambling activity is conducted as a trade or business, gambling losses would be deductible on Schedule C
- Other expenses of the activity could be deducted.
- Only professional gamblers can deduct wagering losses (to the extent of gambling winnings) in computing (AGI).



GAMBLING

- In 1987 *Commissioner of Internal Revenue v. Groetzinger*, the U.S. Supreme Court held:
 - "...[W]e conclude that if one's gambling activity is pursued full-time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business with the meaning of the statutes with which we are here concerned.



GAMBLING

- Respondent satisfied that test in 1978.
- Constant and large scale effort made.
- Skill was required and was applied.
- He did what he did for a livelihood, though with a less-than successful result.
- This was not a hobby or a passing fancy or an occasional bet for amusement. G
- Gambled at tracks in Florida and Colorado.



GAMBLING

- He went to the track 6 days a week for 48 weeks in 1978.
- He spent a substantial amount of time studying racing forms, programs, and other materials.
- He devoted from 60 to 80 hours each week to these gambling related endeavors.....
- kept a detailed accounting of his wagers and every day noted his winnings and losses in a record book.



GAMBLING

- In 1978, gross winnings of \$70,000; bet \$72,032; realized a net gambling loss for the year of \$2,032."
- The important considerations here which are applied in IRS audits are:
 - Full-Time,
 - With Regularity,
 - Production of Income, and
 - Livelihood.



GAMBLING

- Trade or business is full-time. The IRS is taking a strong stance on the full-time requirement by denying upon audit the professional gambler status for an individual who holds full-time employment or files another unrelated Schedule C business activity.
- The concept of full-time is not defined by federal statutes and is generally relegated to employers to define.



GAMBLING

- full-time is construed - between 32 and 40 hours per week.
- individuals can hold down two full-time jobs or attend school full-time and hold down a full-time job.
- Based on the IRS's position, it may be up to the courts to make the determination based on facts and circumstances.



GAMBLING

- Prior the courts were interpreting a “trade or business” to include the offering of goods or services to at least one other individual – exempted gamblers.
- “Goods or Services” requirement has since been rejected replaced with “facts and circumstances” principle.



GAMBLING

- In *Baxter*, the court rejected the contention that the “goods and services” test was an absolute prerequisite to a finding that the poker player engaged in a trade or business.
- Court held - frequency, extent, and regularity of a professional gaming activities in addition to his or her intent to derive a profit were sufficient to meet the definition of a trade or business under the relevant Code sections.



GAMBLING

- Court ruling - poker player's gaming income was derived entirely from his personal services, capital was not a material income-producing factor and was merely a "tool of the trade" used to finance his poker playing.



GAMBLING

■ Losses Limited to Income

- Originally, the IRS maintained that a professional gambler could not have a Schedule C which reflected a loss. This was based on the interpretation that under §165(d), losses from gambling could not exceed gains from winnings.
- In *Mayo v. Commissioner*, court that ordinary and necessary business expenses incurred by the professional gambler other than wagering expenses could be deducted in excess of winnings.



GAMBLING

- **Recordkeeping Requirements**
- Good recordkeeping essential. Gambling requires a contemporaneous written gambling log.
- Online gamblers are known to play dozens of hands simultaneously using multiple computers and monitors. There is software available which allows the user to monitor each poker session's profit or loss, hands played, and time played.



GAMBLING

- IRS91 provides guidelines for wagering recordkeeping:
- 1. An accurate diary or similar record regularly maintained by the taxpayer, supplemented by verifiable documentation usually will be acceptable evidence for substantiation of wagering winnings and losses. In general, the diary should contain at least the following information:



GAMBLING

- 1) Date and type of specific wager or wagering activity;
- 2) Name of gambling establishment;
- 3) Address or location of gambling establishment;
- 4) Name(s) of other person(s) (if any) present with taxpayer at gambling establishment; and
- 5) Amount(s) won or lost.



GAMBLING

- 2. Verifiable documentation includes, but is not limited to Forms W-2G; Forms 5754, wagering tickets, canceled checks, credit records, bank withdrawals and statements of actual winnings or payment slips provided by the gambling establishment.
- Any other formal documentation.



GAMBLING

- documentation includes, but is not limited to, hotel bills, airline tickets, gasoline credit cards, canceled checks, credit records, bank deposits, and bank withdrawals. Additional supporting evidence could also include affidavits or testimony from responsible gambling officials regarding wagering activity.



GAMBLING

- 3. With regard to specific wagering transactions, winnings and losses may be further supported by the following items:
 - 01 Keno—copies of keno tickets purchased by the taxpayer and validated by the gambling establishment;
 - 02 Slot machines—a record of all winnings by date and time that the machine was played;



GAMBLING

- 03 Table games: 21 (blackjack), craps, poker, baccarat, roulette, wheel of fortune, etc.—the number of the table at which the taxpayer was playing, and casino credit card data indicating whether the credit was issued in the pit or at the cashier's cage;
- 04 Bingo—a record of the number of games played, cost of tickets purchased and amounts collected on winning tickets;



GAMBLING

- 05 Racing: Horse, Harness, Dog, Etc.—a record of the races, entries, amounts of wagers and amounts collected on winning tickets and amounts lost on losing tickets. Supplemental records include unredeemed tickets and payment records from the racetrack; and
- 06 Lotteries—a record of ticket purchases, dates, winnings and losses. Supplemental records include unredeemed tickets, payment slips and winnings statement.”



GAMBLING

- **Example:** A taxpayer was able to substantiate his slot machine losses, even though he kept no log, where he was able to produce all his receipts (ATM withdrawals, copies of checks, and credit card statements), as well as testimony from his girlfriend who accompanied him, his return preparer, an expert on gambling illnesses, and a slot machine expert.



GAMBLING

- **Example:** A taxpayer was denied his claimed status as a professional gambler because he did not maintain any receipts, books or records but instead relied solely on the casino to track all of his playing time, betting history, wins, and losses on his Player's Club card.



GAMBLING

- Courts have in some instances allowed some estimates for gambling losses based on the Cohan rule where one may rely on reasonable estimates provided there is some factual basis.
- Consistent with the Cohan rule - taxpayer must have some basis upon which to establish an estimate.
- All earnings must be reported.



GAMBLING

- **Gambling Session**
- In actual practice whether a gambler wins or loses is often defined by the gambling “session.”
- No court cases or Revenue Rulings that provide a definition of a gambling session. Generally, a “session” relates to a set period of time that has a beginning and end.



GAMBLING

- the generally accepted definition of a gambling session from tax professionals that specialize in professional gamblers is that a gambler can net results in two or more different games/tables if they were the same game played continuously without cashing out. Under this definition, a session could encompass several tables or slot machines played over many hours.



GAMBLING

- document all of the table or machine numbers played during a session.
- Most casinos provide player cards where machine play can be recorded
- Table games may not be recorded by the establishment.



GAMBLING

What is a session?

- Cashing in chips
- Meal/bathroom breaks
- Moving from one type of game to another
- Changing casinos



GAMBLING

- **State Taxes and Gambling**
- The general rule is income earned by a taxpayer performing services in, or from property located in a non-resident state is subject to income tax on those earnings by that non-resident state, i.e., income may be taxed by the state it is earned in. This is not necessarily true for gambling winnings.
- Need to check each state's rules. Winnings losses and phantom income rules.



GAMBLING

- Generally, internet gambling would only be taxable in a resident state regardless of where the computer activity took place. Just because a gambler may qualify as a professional gambler does not mean he must file on Schedule C.



GAMBLING

- In the case of a dependent, there may be four choices of filing:
 - amateur dependent,
 - amateur non-dependent,
 - professional dependent and
 - professional non-dependent.



GAMBLING

- **Casino Gambling and Comps**
- At their discretion, casinos often dispense complimentary items to players to encourage them to gamble. These benefits are commonly referred to as “comps”. The number and nature of comps that are given to particular player usually depends on the type of game they are engaged with, the amount of their bets, and the duration of their play.



GAMBLING

- Comps can range in value from free beverages to free meals, hotel rooms, air and ground transportation, entertainment tickets, and personal property such as a Rolls Royce in one instance. One case indicates the total value of comps given to a recreational gambler over a three-year period to be \$2.5 million, reported by the casino on a 1099-MISC as prizes and awards.



GAMBLING

- It is generally accepted that some comps represent taxable income, although few if any gamblers report beverages, meals or hotel rooms on their income tax returns. An additional issue turns on whether comps, if and when included in income, can be considered wagering income to offset wagering losses. The short answer is yes.



GAMBLING

- The language of §165(d) says that “Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.” The Tax Court found that the plain meaning of the word “gains” included other income derived from wagering such as comps, not just winnings. If the legislature had meant to include only winnings it would have said so.



GAMBLING

- **Case Studies: LaPlante vs Commissioner and Pham & Nguyen vs. Commissioner**



CLERGY

- Section 107 of the IRC refers to “Ministers of the Gospel”, which includes leaders from a variety of faiths or beliefs, if the person meets certain tests outlined below. These individuals have historically enjoyed some favored tax treatments regarding their incomes.



CLERGY

- As recently as December 2014, a U.S. District Court in Wisconsin dismissed a lawsuit brought by two non-religious nonprofit organizations who contended that the provision 78 that the housing allowance for clergy is not includable in taxable income is unconstitutional.



CLERGY

■ **Definition of a Minister**

- Has been ordained, licensed or otherwise commissioned by a religious body that
- constitutes a church or denomination (required),
- Conduct religious worship,
- Administer ordinances or sacraments,
- Manage responsibilities in the local church or parent denomination, and
- Are considered to be religious leaders by the church or parent denomination.



CLERGY

- The five factors that are applied to a minister can also be applied to a pastor, priest, rector, rabbi, Jewish cantor, Muslim imam, Christian Science practitioner, etc.
- The courts and the IRS require that a person be ordained, commissioned, or licensed, and then a balancing test is applied regarding the other four factors.



CLERGY

- An earlier court case established these five tests and ruled that a minister had to meet all five tests to be a minister. While the IRS has adopted the less stringent standard, and uses it in the ministerial audit technique guide (and therefore this less stringent standard may be used in dealing with the IRS), the more stringent standard has been applied in some subsequent court cases.



CLERGY

- Even if a person meets the above tests, the IRS may still not recognize their status as a minister.
 - a parent denomination does not recognize the ordination action of the local church,
 - the local church's bylaws or charter do not authorize the conferring of ministerial credentials,
 - the church does not have a history of conferring credentials, or
 - there is no change in job functions or responsibilities after the conferring of ministerial status.



CLERGY

- The tax benefits of being a minister will almost certainly be denied if the church conferred the credentials only to allow the minister access to the tax benefits of being a minister and there was no change in the job responsibilities.
- Some ministers of youth, education, music, etc., may also qualify as having ministerial status if they have been duly ordained, commissioned or licensed and earn their compensation in the exercise of the ministry by a church body.



CLERGY

- Some who are ordained but whose job duties are only partially those traditionally performed by ministers may qualify.
- Others may not simply because they do not meet some of the tests, e.g. a chaplain in the military service as he is an employee of the defense department and not the church.



CLERGY

- Ordained, commissioned, or licensed ministers employed by institutions that are integral agencies of religious organizations constituting a church or church denomination may also be subject to special tax treatment similarly to ministers employed by a church as all services performed for such an institution is considered to be in the exercise of ministry.⁷³



CLERGY

- An institution is an integral agency based on eight criteria- RR 72-606:
- 1) whether the religious organization incorporated the institution;
- (2) whether the corporate name of the institution indicates a church relationship;
- (3) whether the religious organization continuously controls, manages, and maintains the institution;



CLERGY

- (4) trustees or directors of the institution are approved by or must be approved by the religious organization or church;
- (5) trustees or directors may be removed by the religious organization or church;
- (6) annual reports of finances and general operations are required to be made to the religious organization or church;
- (7) the religious organization or church contributes to the support of the institution;
- (8) In the event of dissolution of the institution its assets would be turned over to the religious organization or church.



CLERGY

- A church employee such as a secretary, clerk, or janitor does not qualify for ministerial status.
- An ordained or commissioned minister who only performs services of a routine nature, such as a secretary, clerk, or janitor, will not qualify as a minister for tax purposes.



CLERGY

- **Example:** Mike, a duly ordained minister, is engaged to perform service as chaplain at Acme University. Mike devotes his entire time to performing his duties as chaplain which include the conduct of religious worship, offering spiritual counsel to the university students, and teaching a class in religion. Mike is performing service in the exercise of his ministry.



CLERGY

- **Example:** Neil, a duly ordained minister, is engaged by Acme University to teach history and mathematics. He performs no other service for the university although from time to time he performs marriages and conducts funerals for relatives and friends. Acme University is neither a religious organization nor operated as an integral agency of a religious organization.



CLERGY

- Neil is not performing the service for the university pursuant to an assignment or designation by his ecclesiastical superiors. The service performed by Neil for Acme University is not in the exercise of his ministry. However, service performed by Neil in performing marriages and conducting funerals is in the exercise of his ministry.



CLERGY

- **Special Tax Rules**
- Ministers are entitled to a number of beneficial provisions in the Internal Revenue Code.
 - Housing or parsonage allowance, and the parsonage fair rental value if the parsonage is owned by the church, are excluded from federal income tax,



CLERGY

- Exemption of some qualified clergy from social security coverage,
- Treatment of clergy as self-employed for social security tax purposes with respect to ministerial services even though they are generally employees of the church, and
- Exemption of clergy wages from income tax withholding.



CLERGY

- **Housing Allowance**
- In some instances, the church or religious body owns a home (usually referred to as a parsonage) or other housing accommodation and allows the clergy member to live there without charge, and the value of this rent-free accommodation does not have to be included in income.



CLERGY

- In other cases, the clergy member must provide his or her own living accommodations, but an amount (the "Housing Allowance") is paid to the clergy member to cover the cost of the purchase or rental of a dwelling. Under code §107(2), this amount is not includable in the minister's gross income.
- It is not unusual for retired ministers to have 100% of their retirement income designated as a housing allowance, and therefore be tax-free.



CLERGY

- Some church organizations will pay a minister a certain amount so that the minister can take care of and pay for the furnishings and utilities of a church-provided parsonage (sometimes referred to as a “Parsonage Allowance”). This parsonage allowance is also not includable in the minister’s income to the extent that it is compensation for ministerial services and used to pay for the aforementioned expenses.



CLERGY

- The housing allowance must be formally established by written resolution of the church governing body (board, council, etc.) of the employing church prior to the year for which it is paid. This must be done each year. A resolution not timely made will result in the disallowance of any housing allowance that was paid prior to the adoption of the resolution.



CLERGY

- Increases are allowed, but are only effective for the period after the adoption of a resolution indicating such an increase.
- The housing allowance is limited to the least of:
 - The amount excluded from taxable compensation,
 - The amount actually spent on rent or the actual cost of providing the home, or
 - The fair market rental value of an equivalent home, including furnishings and utilities.



CLERGY

- **Example:** Each year Reverend Bob receives a housing allowance of \$20,000 from his church. In 2016, he had to make major repairs to his home in addition to his normal payments, and he ended up paying out a total of \$28,000 toward his housing costs. The house that Bob lives in is fully furnished, and all of the utilities are paid. On the open market the house would rent for \$2,000 a month (\$24,000 a year). Bob is limited to excluding no more than \$20,000 from his 2016, which is the lowest of the three qualifiers.



CLERGY

- **Determining Fair Rental Value of the Home.**
The facts and circumstances of the local real estate market dictates what the fair rental value of the home would be. If the minister rents his home, the amount of the rent paid would generally be evidence of its fair rental value.



CLERGY

- Some other methods to substantiate fair rental value may include:
 - documentation provided by local realtors who have offered similar properties for rent,
 - online listings, real estate flyers or newspapers advertising the rent of similar properties in the same general area, or
 - local government surveys of rent paid for similar housing in the same general neighborhood.



CLERGY

- **Excludable Housing Expenses.** Most household expenses can be included in the housing allowance. Examples include:
 - a downpayment on a home,
 - mortgage payments (including both principal and interest),
 - home equity loan payments (if the loan proceeds are used for expenses related to housing),



CLERGY

- real estate taxes; property insurance;
- Utilities; furnishings;
- appliances (including repairs); structural repairs;
- Remodeling; yard maintenance & improvements;
- pest control; snow removal; garbage service.



CLERGY

- Ministers are not permitted to take a home office deduction. Ministers are allowed to deduct the cost of home mortgage insurance, real property taxes, and any home-related casualty losses as itemized deductions, even if they receive a housing allowance.
- The cost of food and/or servants may not be included. Only expenses that have been incurred in a given year can be included in the housing allowance for that particular year.



CLERGY

- **Example:** Pastor Mike needs to repair his home's bathroom floor, replace the roof and paint the house. The church approves an additional \$25,000 in housing allowance to cover these costs. However, Mike does not make the improvements to his home. Since Mike did not incur the additional expense in that year, he will not be able to exclude the additional \$25,000 from income.



CLERGY

- It is essential for a minister to keep canceled checks, charge card records, invoices and original receipts to substantiate housing expenses.
- Some churches will calculate the actual housing exclusion for their minister in January using receipts, etc., submitted by the minister.



CLERGY

- If the church uses an estimated exclusion method (the minister estimates the excludable amount and the church reduces the W-2 wages by this amount) or a non-accountable method (the minister requested an amount not based on estimates), there may be an amount excluded on the W-2 or 1099-MISC in excess of the allowed exclusion.
- If this is the case, the excess must be included back into income. This is done by adding the excess to line 7 wages on the Form 1040, or to income on the Schedule C, whichever is appropriate.



CLERGY

- **Housing Allowance for SE Purposes.** The housing allowance exclusion only applies for federal *income tax* purposes. The excluded parsonage or housing allowance is combined with other clergy wages and is generally subject to self-employment tax.



CLERGY

- **Example:** A church pays its pastor an annual salary of \$45,000 and provides him with a church-owned parsonage. The church pays for all the expenses of maintaining the home. The fair rental value of the parsonage is \$12,000 a year. The pastor's gross income for federal income tax purposes is \$45,000, but for self-employment tax purposes his gross income is \$57,000.



CLERGY

- An allowance paid to a retired minister (or the rental value of a provided parsonage) is not includable in SE income.
- **Impact on 403(b) Pension.** The housing allowance exclusion is not part of “includible compensation” for certain contribution limitations established by the IRS.



CLERGY

- **Self-Employment Tax**
- **Exemption from SE Taxes.** If a member of the clergy (or member of a religious order who has taken a vow of poverty) is opposed for religious reasons to the acceptance of Social Security benefits, then he or she may request an exemption from the IRS from paying Self Employment taxes. 99



CLERGY

- The exemption is not effective until it is approved by the IRS. The request and the approval are on Form 4361 *Application for Exemption From Self-Employment Tax for Use By Ministers, Members of Religious Orders and Christian Science Practitioners*. The minister should retain and be able to present a copy of the approved Form 4361 if the IRS is auditing in this area.



CLERGY

- Form 4361 must be filed by the due date of the taxpayer's tax return, including extensions, for the second tax year in which he or she had at least \$400 of net earnings from self-employment, of which any amount was from services as a minister.



CLERGY

- The acceptance of Social Security benefits is fairly narrowly defined as the acceptance of Social Security benefits payable as a result of the minister's services performed in the exercise of ministry. This has two impacts on the minister. First, the exemption applies only to income earned in the exercise of ministry.



CLERGY

- If the minister has income subject to SE taxes or FICA taxes outside of the ministry, then those wages are not treated differently for the minister. Second, if a minister is not eligible for Social Security benefits based on his ministry earnings, then he or she may still be eligible for spousal benefits, although reduced due to windfall provisions.



CLERGY

- Note that members of recognized religious sects (or a division of that sect) can also request an exemption from SE taxes and from payment of social security and Medicare taxes on wages earned from the sect by filing Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*.



CLERGY

- See the instructions for Form 4029, or from IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.



CLERGY

- Ordained, commissioned or licensed ministers are subject to dual-status for reporting income.
- For federal income tax reporting purposes, most ministers are considered to be employees.
- However for social security purposes, they are regarded as self-employed.
- Ministers, as employees, are allowed certain fringe benefits, such as employer paid health insurance premiums, life insurance premiums, cafeteria plans, and contributions to participate in 403(b) plans.¹⁰⁶



CLERGY

- Also, ministers may be reimbursed for business expenses if the reimbursements are part of an “accountable plan,” or they are eligible to claim those expenses as unreimbursed employee business expenses if not directly reimbursed (subject to the Deason rule, covered later).



CLERGY

- **Wages.** Compensation paid to ministers for services performed “in the exercise” of ministry may also receive special treatment.
- Such compensation is reported as wages on a W-2 and includes taxable salary, as well as taxable fringe benefits, group term life insurance premium for coverage in excess of \$50,000, auto allowance, offset payments, non-qualified moving expense payments and, in some cases, a social security allowance.



CLERGY

- A church-designated housing allowance should not be included in the W-2 as wages.
- **Example:** Pastor Pete is paid total compensation of \$49,378. \$30,000 of his compensation is a designated housing allowance and is not included in wages. The remaining \$19,378 is reported as wages.



CLERGY

- The church should generally not withhold income taxes or FICA taxes from the minister's pay.
- The compensation of a minister earned in the exercise of the ministry is specifically excluded from mandatory federal income tax withholding as well as FICA tax withholding.
- Ministers should file quarterly estimated taxes.



CLERGY

- If the minister is treated as an employee, then there is a voluntary election to have withholding taken from his or her pay. This is generally done by filing a Form W-4 with the employer church. This election can be revoked at any time, either by the minister or by the employing church. This does not apply to FICA taxes, as for this purpose ministers are considered self-employed.



CLERGY

- Therefore, unless exempted, the minister calculates SE taxes on Schedule SE for his total net income (wages, SE income, and housing allowance).



CLERGY

- **Gifts.** Whether a gift is taxable depends on who has given it and why. All cash “gifts” given to the minister directly by the employer or solicited from individual members (in an organized manner) are taxable compensation and should be included in the W-2.
- Gifts received directly from individual congregation members for reasons other than compensation for services are not taxable as income to the pastor, but they are also not tax deductible by the giver¹¹³



CLERGY

- “Gifts” given as compensation for services, such as for performing weddings or funerals, should be included on the tax return as self-employment income, and again are not tax deductible by the giver. Such gifts include both cash and the FMV of any property given.
- “Service award” is not taxable if it is a tangible gift, unless it has a high monetary value or the tangible gift is given frequently. However, awards of cash or gift certificates are considered as wages.



CLERGY

- **Foregoing Full Salary Offered.** Often, in an effort to help the congregation, a minister will forego a full salary. If, however, the minister receives goods or services in lieu of cash income, then under the “constructive receipt doctrine,” the fair market value of the goods or services should be considered to be constructively received and should be included in taxable wages.



CLERGY

- **Example:** a tuition reduction to send the minister's child to a school operated by the congregation. A minister should not deduct as a charitable donation the difference between the amounts received and what would be considered a full salary.



CLERGY

- **Schedule A Deductions**
- **Unreimbursed Employee Business Expenses & the “Deason” Rule.** The “Deason Rule” is named for a tax court decision, *Deason v. Commissioner*, 41 T.C. 465 (1964). This rule affects only clergy with unreimbursed business expenses who are eligible to take a business expense deduction for those expenses.



CLERGY

- IRC section 265(a)(1), states that a clergy person who benefits from the housing allowance exclusion must reduce his or her business deduction in proportion to the amount of income that is excluded from tax by the housing allowance. This rule applies to both employee compensation and self-employment income.



CLERGY

- **Example:** Ned, a commissioned minister, receives a salary of \$40,000, plus a housing allowance of \$20,000. He has unreimbursed business expenses of \$6,000, which, for purposes of this example, are assumed to be deductible. His total “ministry” income is \$60,000 (\$40,000 plus \$20,000 housing allowance).



CLERGY

- The exempt portion of his income (the \$20,000 housing allowance) is one-third of the total. Thus, he must reduce the otherwise deductible unreimbursed business expenses by \$2,000 ($\$6,000 \times \frac{1}{3} = \$2,000$), and is only able to deduct \$4,000.



CLERGY

- The “Deason Rule” can be avoided by having the church adopt an accountable plan. It should be noted that the “Deason Rule” does not apply when computing self-employment taxes. For that calculation, because the housing allowance is fully taxable for SE tax, then 100% of the unreimbursed business expenses are deductible in computing SE income.



CLERGY

- **Mortgage Interest and Real Estate Taxes.** Although mortgage interest and property taxes may be considered when determining the housing allowance exclusion, they may also be claimed as deductions on the Schedule A. This is referred to as the double deduction, but from a tax standpoint it is an exclusion and a deduction, albeit on the same expense.



CLERGY

- It is possible for these items to be excludable from income as part of the housing allowance, and then allowed again as a deduction if the minister itemizes his deductions. In this instance, this is allowed. As mentioned previously, ministers are not permitted a home office deduction and cannot claim their mortgage interest or property taxes as home office expenses.



CLERGY

- **Charitable Contributions.** Reductions in salary or wages are not considered charitable contributions. The best way for a minister to claim a deduction for the gifts and contributions given to the church is to make a contribution and itemize deductions on Schedule A, just as lay persons.



CLERGY

- If a specified amount or percentage (tithe) is deducted from the minister's paycheck, his taxable wages cannot be reduced by the amount of the contribution.
- **Case Study: Cortes & Cortes vs. Commissioner of Internal Revenue**



MILITARY

- **Military Taxpayers**
- Given the nature of their duties that may take them all over the world at short notice, while placing them into dangerous environments, members of the US Armed Forces are granted certain tax treatment privileges that do not apply to other taxpayers.



MILITARY

- **Filing Deadlines**
- **Due Date for Form 1040 – April 15**
- Delayed by two months to June 15 for service members who are stationed outside the US and Puerto Rico on April 15.
- A service member can receive an automatic 6-month extension if inside the US or Puerto Rico



MILITARY

- **Outside the US and Puerto Rico.** Automatic 2-month extension of time without needing to file Form 4868.
 - The service member both lives, and has his or her main place of business or post of duty, outside the US and Puerto Rico, or
 - For a period that includes the entire due date of the return, the service member is in military or naval service on an assigned tour of duty outside the US and Puerto Rico.



MILITARY

- Balance Due: interest will be assessed for the period from the regular due date until the final amount of tax is paid. Service members who take advantage of the automatic 2-month extension should attach a statement to their tax return indicating that he or she met the requirements for the extension.



MILITARY

- Service members who wish to obtain a further 4-month extension to October 15, 2018 for their 2017 tax return must file Form 4868 by June 15, 2018.



MILITARY

- **Joint Returns.** using the automatic 2-month extension, only necessary for one of the spouses to meet the related requirements.
- **Separate Returns.** using the automatic 2-month extension will only be granted if he or she meets the requirements.



MILITARY

- **Payment of Tax.** An extension of time to file has no bearing on a service member's due date for the payment of any outstanding tax. Although a service member must estimate his or her tax due, he or she is not required to include any payment of tax due when filing Form 4868.



MILITARY

- Paying Late: interest will accrue from the regular due date up until the date the tax is paid.
- Penalties for late payment may also be applied unless the service member can demonstrate reasonable cause for not having paid the tax at its original due date.



MILITARY

- Payments: Same as regular tax payers by using a credit/debit card or online funds withdrawal from an account.
- **Exception.** If military service has materially affected his or her ability to pay income tax obligations that arise before or during service, he or she may qualify to defer the payment of those obligations.
- Payment be deferred for up to 180 days after the service member's termination or release from military service. No interest or penalty will be charged for the period of deferment provided that the service member pays his or her income tax obligation in full on or before the last day of the deferral period.



MILITARY

- This exception applies only to income tax, and not the employee's share of Social Security and Medicare taxes.
- Requests for deferral of tax payments under the above program must be made in writing. However, there is no particular form that must be used for this purpose.



MILITARY

- A service member with a current payment agreement in place must send his or her deferral request to the same IRS office with which the current agreement was made.
- Service members who do not currently have payment agreements must wait until they have received an IRS notice. They must then make their request for deferral with the same IRS office that issued their notice.



MILITARY

- All deferral requests must include the following information regarding the service member:
 - name,
 - Social Security number,
 - current monthly income,
 - military rank,
 - military service entry date,
 - discharge eligibility date.



MILITARY

- A copy of the military orders of the service member should also be included, if possible, with the deferral request.
- Approval of the request is not granted automatically. Each request for deferral is reviewed by the IRS and the service member is then notified in writing.



MILITARY

- **Extended Deadlines**

- Income tax, estate tax, gift tax, employment tax, excise tax, IRA, Credits and refunds, Notices and collections, Tax Court

- **Service That Qualifies for an Extension.**

Serving in a combat zone or contingency

Automatic Extensions:

- performing qualified service in or out of a combat zone, including any time spent in a missing status.
- deployed on a contingency operation, outside the United States and away from their permanent duty station.



MILITARY

- Support personnel who are serving in a combat zone or contingency operation in support of the Armed Forces, including civilians acting under Armed Forces direction, accredited correspondents, and the Red Cross.
- **Extensions for Spouses.** The same deadline extensions, with two exceptions, also apply to the spouses of individual service members or support personnel who served in a combat zone or contingency operation.



MILITARY

- The extension does not apply:
 - for any tax year beginning more than two years after the operation ceases to be a contingency operation, or the area ceases to be classified as a combat zone.
 - for any period that the qualifying individual is hospitalized in the United States as a result of injuries suffered in incurred in a contingency operation or combat zone.



MILITARY

- **Combat Zone.** A combat zone is any area designated by Presidential Executive Order in which the U.S. Armed Forces are engaging, or have engaged, in combat. The airspace above a combat zone is included in the combat zone.
- **Contingency Operation.** A contingency operation is a military action that meets at least one requirement from each column in the chart, below.



MILITARY

- Contingency Operation
- What
 - Designated by the Secretary of Defense,
 - Results in calling members of the uniformed services to active duty, or
 - Retains members of the uniformed services on active duty.
- When
 - During a war, or During a national emergency.
- Declared by
 - The President, or Congress.



MILITARY

- **Military Service** .The length of an individual's military service is defined the period between the date when the service member enters the service and the date when he or she is either released from military service or dies while in the service.



MILITARY

- **National Guard.** The above provisions also apply to National Guard members if:
 - They are under a call to active service for a period of more than 30 days by the Secretary of Defense or the President, and
 - The call to active service has been made in response to a national emergency declared by the President and supported by federal funds.



MILITARY

- **Joint Returns for Military Couples**
- If one spouse is absent because of military duty or is incapacitated and unable to sign a joint return, the filing spouse may sign on behalf of the absent or incapacitated spouse using one of these options.



MILITARY

- **Income**
- As part of their overall compensation package, members of the Armed Forces may receive numerous different types of pay and allowances, of which some are included in gross income while others are excluded. Some examples are as follows:



MILITARY

- Included Items:
 - Basic Pay
 - Special Pay
 - Bonus Pay
 - Incentive Pay
 - Other Pay



MILITARY

- Excluded Items:
 - Combat zone pay
 - An area which has been classified as a combat zone by an executive order issued by the President;
 - Death allowances
 - Moving allowances
 - Living allowances
 - Travel allowances
 - Family allowances
 - In-kind military benefits
 - Other pay



MILITARY

- An area which has been designated by Congress as a qualified hazardous duty area where the service member is receiving hostile fire or imminent danger pay according to 37 U.S. Code §310; or
- Direct support (as certified by the DOD) of military operations in a combat zone or qualified hazardous duty area, and the service member is receiving hostile fire or imminent danger pay even though he or she is not located in the combat zone or qualified hazardous duty area.



MILITARY

- This term generally used for this type of compensation is “combat pay.” For IRA purposes, a service member’s compensation includes nontaxable combat pay. This means that even though the combat pay does not have to be included in gross income, it is included in compensation when figuring the limits on contributions and deductions of contributions to IRAs.



MILITARY

- This exclusion does not need to be shown on the service member's tax return because any income that meets the criteria for the combat zone exclusion is not reflected in the wages reported on his or her Form W-2.
- Service members can only receive combat pay for a month in which he or she either served in a combat zone or due to wounds, disease, or injury incurred while serving in the combat zone was hospitalized.



MILITARY

- The service member's combat pay can be excluded from income regardless of whether he or she receives that pay while still physically present in the combat zone or recuperating in the hospital. Similarly, the combat pay remains excludable even if received in a year later than the member's actual combat zone service.



MILITARY

- **Enlisted Service Members, Warrant Officers, and Commissioned Warrant Officers – Excluded Amounts:**
 - Pay earned in any month they served on active duty in a combat zone.
 - Imminent danger/hostile fire pay.
 - A re-enlistment bonus, provided that the voluntary extension or re-enlistment occurs in a month the member was serving in a combat zone.



MILITARY

- For those members who are hospitalized, military pay they received for any month of service that begins within 24 months after the cessation of combat activities in the combat zone. It is not required that the member's hospitalization take place in the combat zone.
- Pay for unused leave the member earned in any month that he or she served in a combat zone, subject to determination by the DOD that the member accrued the leave during his or her period of combat zone service.



MILITARY

- Pay earned in a month the member served in a combat zone, even though their official duties were in regard to messes, clubs, theaters, or other non-appropriated fund activities.
- Awards that the member earned while serving in a combat zone in return for the submission of suggestions, inventions, or scientific achievements.



MILITARY

- Part or all of the student loan repayments made on behalf of the service member during his or her service in a combat zone, according to the number of months served. A service member who served in a combat zone for 7 months, for example, can exclude 7/12ths of the repayment.
- The following amounts **cannot** be excluded:
 - Retirement pay.
 - Pensions.



MILITARY

- **Commissioned Officers (Other Than Commissioned Warrant Officers).** These service members can exclude certain income according to the rules discussed above. However, unlike the lower ranks, there is a limit on the amount these officers can exclude.



MILITARY

- The limit is based on the highest rate of enlisted pay (plus hostile fire/imminent danger pay they received) for each month during any part of which they either served in a combat zone or were hospitalized as a result of that service. For 2016, the limit is \$7,997.10 for the highest enlisted pay, plus \$225 for imminent danger pay (i.e. \$8,222.10 per month).



MILITARY

- **Partial (month) Service.** Service members are entitled to an exclusion for an entire month if they serve in a combat zone for any part of one or more days during that month.



MILITARY

- **Form W-2.** As stated earlier, military pay excluded from a service member's income under the combat zone exclusion provisions should not be included in the amount shown in box 1 of a service member's 2016 Form W-2. In cases where an error of this type has been made, the service member must contact his or her Finance office to obtain a corrected W-2.



MILITARY

- **Serving in a Combat Zone.** Service members who are assigned on official temporary duty to a combat zone or qualify for hostile fire/imminent danger pay are considered to be serving in a combat zone.



MILITARY

- Combat zone service includes any periods that a service member is absent from duty because of sickness, wounds or leave. Service members who are missing in action following their combat zone service or are prisoners of war are also regarded as engaging in combat zone service for as long as they retain that status for military pay purposes.¹⁶³



MILITARY

- **Service Outside Combat Zone Considered Service in Combat Zone.**
- Service outside a combat zone is also regarded as combat zone service if:
 - The service is classified by the DOD as being directly in support of military operations in the combat zone, and
 - The service qualifies the individual for hostile fire/imminent danger pay under 37 U.S. Code §310.



MILITARY

- Provided that the above requirements are met, and the military pay received for this service can be verified through military pay records, the pay will qualify for the combat zone exclusion.



MILITARY

- **Nonqualifying Presence in Combat Zone.** The examples of presence in a combat zone that do not qualify for the exclusion of income:
 - A service member on leave from a duty station located outside the combat zone spends some time in the combat zone.
 - A service member en route between two locations outside the combat zone passes through or over the combat zone during his or her journey.
 - A service member spends some time in a combat zone purely for his or her own personal convenience.



MILITARY

- **Adjustments to Income**
- **Moving Expenses.** Active duty service members who move because of a permanent change of station, are not required to meet the time and distance tests that apply to other taxpayers. They can simply deduct their unreimbursed moving expenses on Form 3903, *Moving Expenses*, taking¹⁶⁷ into account the following definitions.



MILITARY

- **Permanent Change of Station.** A permanent change of station for the service member includes:
 - A move from home to his or her first post of active duty,
 - A move from one permanent post of duty to another,
 - A move back from his or her last duty post to his or her home, or to a closer point in the United States. This move must take place within 1 year of the service member's end of active duty or within the period otherwise allowed under the Joint Travel Regulations.



MILITARY

- **Spouse and Dependents.** When a service member is imprisoned, deserts, or dies, a permanent change of station for his or her spouse or dependents includes a move to:
 - The member's place of enlistment or induction,
 - The spouse's, dependent's, or the member's home of record, or
 - A closer point in the United States.



MILITARY

- In a case where the military moves the spouse or dependent to one location and the service member is moved to a different location, the moves are together regarded as a single move to the spouse's or dependent's new main job location.
- **Foreign Moves.** A foreign move is defined as a move from one foreign country to another, or from the US or its possessions to a foreign country. A move in the opposite direction, i.e., to the US or its possessions from a foreign country is not regarded as a foreign move.



MILITARY

- The deductible moving expenses for foreign moves also include the reasonable expenses of:
 - Moving the service member's personal effects and household goods to and from storage, and
 - Storing the above items for part or all of the time that the new job location outside the US remains the service member's main job location.



MILITARY

- **Relocation and Home Sales**
- Under IRC Section 121, exclusion.
- Once every 2 years.
 - Ownership test: the taxpayer owned the home for 2 years or more, and
 - Use test: the taxpayer lived in the dwelling as his or her principal residence for 2 years or more.



MILITARY

- **Exception to Ownership and Use Tests for Service Members.** Because service members are often required to move because of their transfer to a new permanent duty station, in many cases it can be difficult for them to meet the ownership and use tests. In these instances, an exception to the rules can be applied.



MILITARY

- **5-Year Test Period Suspended.**
- **Example:** Mike bought and moved into a home in 2007. He lived in it as his principal residence for the next 3 years. He was then sent on qualified official extended duty with the Navy for the following 6 years, during which time he did not live in the house. Eventually, in 2016 he sold the home at a gain.



MILITARY

- In order to be able to exclude the Section 121 gain on his house, Mike elects to suspend the 5-year test period for the 6 years of his qualifying official extended duty. Those 6 years are thus disregarded and Mike's 5-year test period now consists of the 5 years before he left on extended duty.
- He now meets both the Ownership and Use tests because he owned and lived in the home for 3 years during this 5-year test period.



MILITARY

- **Period of Suspension Limitation.**

Although the suspension of the test period by service members is made by voluntary election, the suspension period is limited to no more than 10 years. In addition, the suspension cannot be made for more than one property at a time. However, service members can at any time revoke their choice to suspend the 5-year test period.



MILITARY

- **Qualified Official Extended Duty.** For the purposes of the 5-year suspension of the test period, members of the Armed Forces are regarded as being on qualified official extended duty when they serve on extended duty:
 - At a duty station at least 50 miles from their main home,
 - While living in Government quarters under Government orders.
 - Service members are regarded as being on extended duty when they are ordered or called to active duty for a period greater than 90 days or for an indefinite period.¹⁷⁷



MILITARY

- **Armed Forces Reservists**
- **Treatment of Income and Expenses**
- **Reservists' Income or Expense**
 - Differential wage payments.
 - Qualified reservist distributions (QRD).
 - Military uniforms.



MILITARY

■ Travel

Members of a reserve component of the Armed Forces with unreimbursed expenses for travel more than 100 miles from their home in relation to their service as a member of the reserves, can deduct those expenses on line 24 of Form 1040 as an adjustment to income, instead of as a miscellaneous itemized deduction on Schedule A.

**Adjusted
Gross
Income**

23	Educational expenses	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ.	24		
25	Health savings account deduction. Attach Form 8889.	25		



MILITARY

- This applies to all unreimbursed expenses during the period between when the reservist leaves home until he or she returns home, not to exceed the amount the federal government generally reimburses its employees for travel expenses. See IRS Publication 463.



MILITARY

- **Member of a Reserve Component.** For this purpose, a member of a reserve component of the Armed Forces is an individual who is in the Army Reserve, Navy Reserve, Marine Corps Reserve, Air Force Reserve, Army National Guard, Air National Guard, Coast Guard Reserve or the Ready Reserve Corps of the Public Health Service.



MILITARY

- **Reporting Travel Expenses.** Reservists who are eligible to claim the deduction for these expenses should begin by completing either Form 2106, *Employee Business Expenses*, or Form 2106-EZ, *Unreimbursed Employee Business Expenses*.
- The portion of the unreimbursed expenses (up to the federal rate) related to reserve-related travel beyond 100 miles from home should then be subtracted from the total on Form 2106 or 2106-EZ and entered on Form 1040, line 24.



MILITARY

- The remaining balance from Form 2016 or 2016-EZ should be entered as an itemized deduction on Schedule A, subject to the 2% AGI exclusion.
- **Case Study: Hildebran & Hildebran vs. Commissioner of Internal Revenue**



TRUCKERS

- Due to the nature of their daily work, truck drivers other transportation workers are faced with a number of tax-related challenges that don't affect ordinary taxpayers.
- Many of the special rules that apply to truck drivers are under the jurisdiction of the Federal Department of Transportation (DOT), which was established by an act of Congress in 1966. The department's mission is to:



TRUCKERS

- “Serve the United States by ensuring a fast, safe, efficient, accessible and convenient transportation system that meets our vital national interests and enhances the quality of life of the American people, today and into the future.”



TRUCKERS

- The DOT regulates trucks and road transportation through its various agencies it and controls transportation in many different forms, and the employees who work in those different areas.



TRUCKERS

- Department of Transportation Agencies
 - Federal Aviation Administration (FAA)
 - Federal Highway Administration (FHWA)
 - Federal Motor Carrier Safety Administration (FMCSA)
 - Federal Railroad Administration (FRA)
 - Federal Transit Administration (FTA)
 - Maritime Administration (MARAD)
 - National Highway Traffic Safety Administration (NHTSA)
 - Office of the Secretary of Transportation (OST)
 - Pipeline and Hazardous Material Safety Administration (PHMSA)
 - Saint Lawrence Seaway Development Corporation (SLSDC)



TRUCKERS

- **DOT Rules for Truck Drivers**
- Starting in 2004, the DOT's Federal Motor Carrier Safety Administration (FMCSA) imposed the following hours of service limits on drivers of trucks carrying property, rather than passengers:



TRUCKERS

- Drivers are not permitted to drive more than 11 hours. After 11 hours of driving, the driver must have at least 10 hours of rest.
- The maximum length of on-duty time for a driver is 14 hours. After 14 hours on duty (possibly including up to 11 hours of driving) the driver must take a rest period of 10 hours or more before being allowed to operate a commercial vehicle.
- Drivers may not serve more than 60 hours on duty within any period of seven consecutive days. In companies with seven days per week operations, the maximum is 70 hours in any eight consecutive days. Drivers may restart the 7/8-day period after taking an off-duty period of at least 34 consecutive hours.



TRUCKERS

- Commercial motor vehicle drivers who make use of the sleeper berth provision must take eight consecutive hours or more in the sleeper berth, in addition to two consecutive hours spent either in the sleeper berth, off-duty, or any combination of the two.
- Drivers are required to maintain a detailed log book to record their compliance with the above hours of service limit rules.



TRUCKERS

- **Common Expenses for a Trucking Business**
- Some of the deductible expenses often incurred by individual drivers or trucking firms include:
 - Association or union dues,
 - Bank fees, e.g. ATM fees while away from home
 - Cell phone and internet data plans, e.g. GPS, Wi-Fi subscriptions
 - Certifications and permits
 - Cleaning supplies for the truck
 - Computers, software, etc.
 - Credit card fees and interest



TRUCKERS

- Depreciation
- Education, e.g. continuing education to maintain a commercial license
- Excise taxes
- State and federal fees, e.g. US Customs
- Fuel and other truck operating costs (actual expenses)
- Insurance, e.g. workers' comp, commercial liability
- Interest on loans or credit cards
- Labor, e.g. casual helpers
- Leases



TRUCKERS

- Licensing fees, e.g. commercial driver's license
- Maintenance and repairs
- Medical exams specific to commercial driver, e.g. DOT physical, sleep apnea test.
- Per diems where applicable
- Safety gear, e.g. gloves for drivers, cargo straps
- Satellite radio, (for weather and traffic information)
- Tolls
- Tools
- Travel expenses, e.g. meals, lodging, showers₉₃



TRUCKERS

- Meals for Transportation Workers While traveling away from home on business, the cost of meals is deductible if the taxpayer needs to stop for substantial rest or sleep in order to be able to perform his or her duties properly. Lavish or extravagant meals are not deductible, but facts and circumstances apply in each case.



TRUCKERS

- Two alternative methods can be used to calculate meal expenses:
 - Actual meal expenses
 - Standard meal allowance
- In either case, the amount of the deduction is limited to 80 percent for transportation workers (see below), and 50 percent for others.



TRUCKERS

- Actual Meal Expenses. If the taxpayer uses the actual expenses method and is reimbursed under an accountable plan, the amount of the reimbursement is not included in income and the taxpayer does not take a deduction for the expense. If the taxpayer is reimbursed under a nonaccountable plan, the reimbursement is included in income and the taxpayer takes a deduction using the appropriate 80 or 50 percent limit.



TRUCKERS

- Standard Meal Allowance
- The standard meal allowance offers an alternative to keeping records of the actual cost of meals. Although it allows the taxpayer to use a set amount for daily meals and incidental expenses - regardless of the actual costs - the taxpayer must still keep timely records to document the business purpose, time and place of the travel.



TRUCKERS

- The log book that truck drivers are required to keep for purposes of the federal hours of service requirements can also be used to record details of the driver's standard meal allowance.
- Taxpayers can use the standard meal allowance method regardless of whether they are reimbursed for traveling expenses, or whether they are employees or self-employed. The standard meal allowance (also known as meals and incidental expenses or M&IE) is updated each year.



TRUCKERS

- Special Rules for Transportation Workers.
- A special standard meal allowance is allowed for taxpayers in the transportation industry. A taxpayer is considered to be working in the transportation industry if his or her duties:
 - Directly involve moving people or goods by airplane, barge, bus, ship, train, or truck; and
 - Regularly requires the taxpayer to travel away from home, and usually involves travel during any single trip to areas where different standard meal allowance rates apply.



TRUCKERS

- For taxpayers of this type, the M&IE allowance is updated each year. As mentioned above, taxpayers in the transportation industry are limited to claiming eighty percent of their meal expenses.
- The eighty percent limit applies to other transportation workers who are subject to the regulations of different DOT agencies and the DOT's hours of service limits, such as:



TRUCKERS

- Federal Aviation Administration: Certain air transportation workers, such as pilots, crew, dispatchers, mechanics, and control tower operators.
- Federal Motor Carrier Safety Administration: Interstate truck operators and bus drivers.
- Federal Railroad Administration: Certain railroad employees, such as engineers, conductors, train crews, dispatchers, and control operations personnel.
- Maritime Administration: Certain merchant mariners.



TRUCKERS

- Per Diem allowance is based on a fixed amount for lodging, meals and incidental expenses that an employer gives to an employee who is away from home on business. A per diem allowance will satisfy the conditions of accountable plans if:
 - The allowance is similar in nature to, and not more than, the federal per diem rates that apply to federal employees¹⁰⁹,
 - The employee can, within a reasonable period of time, provide the employer with an accounting of the times, dates, places, and business purposes of the expenses,²⁰²



TRUCKERS

- The payments by the employer are reasonably limited to those expenses that are ordinary and necessary in the conduct of the business or trade.
- An employee who receives an M&IE only per diem from his or her employer may treat the lesser of the employer's per diem or the Federal M&IE rate for the locality of travel for that day or partial day as deemed substantiated. It is only when the employer pays the actual expenses for lodging directly to the provider of the lodging that a per diem can be treated as an M&IE only per diem.



TRUCKERS

- Employment Issues
- Due to the many different business models in the transport industry, the employment status of truck drivers and transportation workers is often unclear. Depending on the circumstances of a taxpayer's work and job expectations, he or she may be categorized as:



TRUCKERS

- An independent contractor,
- A common-law employee,
- A statutory employee, or
- A statutory non-employee



TRUCKERS

- Employee or Contractor?
- Whether a given worker should be correctly classified as an employee or contractor has a significant impact on the tax compliance obligations of both the employer and employee.



TRUCKERS

- Behavioral Control - Financial Control
- Example: Using his own truck, Bill delivers plants and other supplies for Ben's Horticultural, Inc. at an agreed rate of \$150 per ton. Bill isn't paid for any articles that aren't delivered. During the busy season Bill sometimes leases another truck and engages a driver to complete his contracted obligations. Bill pays all his operating expenses, including insurance coverage.



TRUCKERS

- All equipment is owned or rented by Bill and he is responsible for all maintenance. None of the drivers are provided by Ben's Horticultural. Based on the above facts, Bill is classified as an independent contractor.



TRUCKERS

- Statutory Employees
- Some truck drivers who might otherwise appear to be independent contractors are categorized as statutory employees if the following conditions are met.
- The driver:
 - distributes beverages (other than milk), meat, vegetables, fruit or bakery products, or
 - picks up and delivers dry cleaning or laundry, as an agent of the payer or is paid on commission²⁰⁹



TRUCKERS

- the above services are performed on a continuing basis for the same payer.
- the driver does not have a significant financial investment in the equipment and property used to perform the services (apart from an investment in the transportation used, such as a car or truck).
- the service contract implies or specifically states that substantially all of the services are to be performed personally by the driver.



TRUCKERS

- It is the responsibility of the employer of a statutory employee to withhold social security, medicare and federal unemployment taxes from the driver's wages, but the employer should not withhold federal income taxes.
- Statutory employees should report their earnings and business-related expenses on Schedule C.



TRUCKERS

- Example: Doug delivers bakery products for a local bakery to supermarkets in an assigned area of town. He provides his own delivery truck and is neither reimbursed for maintaining the truck or for the cost of fuel. He is paid a flat fee for each load he delivers.
- His hours and delivery routes are flexible provided each store receives its delivery by a specified time. The agreement between Doug and the bakery is that he must personally deliver the product to each supermarket. Doug is a statutory employee even though he otherwise meets a number of criteria to be treated as an independent contractor.



TRUCKERS

Self-Employment

For all federal tax purposes, direct sellers are treated as self-employed, which includes responsibility for income and employment taxes, if:

- substantially all payments they receive for their services are related directly to their sales or other output, instead of being based on the number of hours worked, and
- They perform their services under a written contract which states that for federal tax purposes they will not be treated as employees.



TRUCKERS

- Case Study: Baker & Baker vs.
Commissioner of Internal Revenue
TC Summary Opinion – 2011-95



PILOTS AND FLIGHT CREWS

- Pilots, Flight Crews & Shipping Crews
- Another occupation that frequently comes under audit is commercial airline pilot and other members of the flight crew. These occupations frequently have high employee business expenses (EBE), and these are what are normally targeted in the audit.



PILOTS AND FLIGHT CREWS

- There are also provisions concerning the Foreign Earned Income Exclusion that frequently arise when discussing flight crews (see Foreign Earned Income below).
- Similar rules apply to U.S. citizens working on international shipping lines, where the ships spend the majority of their time in international waters.
- An exception may be cruise ship personnel, as cruise ships are usually in coastal waters and can be sourced to a particular country. Air crews, however, are audited more frequently than ship crews.



PILOTS AND FLIGHT CREWS

- Uniforms, Dry Cleaning, and Personal Care
- All airlines require that their employees wear the airline's uniform: however, the "uniform" may not include clothing that the airline provides.



PILOTS AND FLIGHT CREWS

- In general, much of the uniform is provided by the employer either through purchase or for use, and meets the definition of being deductible for income tax purposes, i.e. they are not adaptable to general use as ordinary clothing and are not used for such. However, the airline may also set standards for other clothing that the crew member can wear such as a particular type of (non-safety related) shoe, or a requirement to wear pantyhose or ties.



PILOTS AND FLIGHT CREWS

- Where these items of clothing are suitable for street wear or general use, they are not deductible even if required by the airline. Maintenance of uniforms is generally deductible, providing the taxpayer can substantiate the expense.
- Personal hygiene expenses, such as hair or manicures, are inherently personal in nature and are not deductible, regardless of whether an employer requires them as part of the job.



PILOTS AND FLIGHT CREWS

- Commuting
- Many flight crew personnel may live in one city but are based by their airline in another city, requiring them to commute to their base city to work. These two locations may be hundreds of miles apart from each other, requiring the crew member to fly to their base city to work.



PILOTS AND FLIGHT CREWS

- Flight crew members can generally fly for free, or at very little cost, on their own airline utilizing spare seats on the plane.
- Parking fees and tolls paid to park an employee's car at the airport are commuting expenses and are not deductible. Likewise, any fee incurred for a flight from the airport nearest their personal residence and their work location is also a commuting expense.



PILOTS AND FLIGHT CREWS

- Example: A flight attendant who lives in Tampa, Florida. She works for United Airlines, and is based at the Newark, NJ airport. Della parks her car at the Tampa airport, paying for the parking, and takes a flight with United from Tampa to her home base of Newark. She usually flies for free, but if she has to fly as a regular passenger she pays a \$20 “trip pass” fee.



PILOTS AND FLIGHT CREWS

- If she has to stay in Newark between flights, she stays in a hotel room and is not reimbursed by the airline. None of these expenses are deductible, as they are considered to be commuting expenses.
- If flight crew personnel pay for a hotel or maintain an apartment in the city where they are based, they may not deduct the cost as a travel expense. Any meals consumed while staying in the city where they are based are not includable in meal and incidental expenses (M&IE), unless of course they serve some other business purpose of the employer.



PILOTS AND FLIGHT CREWS

- Likewise, any other expenses incurred while in the city they are based are personal expenses and not business, such as mileage driven.
- Flight crews are subject to the Department of Transportation's hours of service limits. Because of this, air crews can deduct 80% of their M&IE, rather than the standard 50% deduction. Generally, lodging expenses are paid for directly by the airlines and are therefore less frequently an issue in examination.



PILOTS AND FLIGHT CREWS

- In general, most U.S. based air carriers have “accountable plans” that reimburse their flight crew personnel on a per diem basis for M&IE. The amount of the per diem may vary according to collective bargaining agreements and other factors negotiated between the airlines and their employees.



PILOTS AND FLIGHT CREWS

- The per diem paid by the employer may or may not be higher than the actual per diem amount under CONUS (Continental US or O-CONUS for overseas travel) for the city to which the crew member is flying and staying over. A flight crew member can elect to use either the per diem method of accounting for M&IE, or use actual expenses.



PILOTS AND FLIGHT CREWS

- Per diem rates are set annually and are effective from October 1 through September 30, which is the government's fiscal year. The per diem rates for all US cities, including historical rates, can be found at the website for the General Services Administration (GSA) at:
<http://www.gsa.gov/portal/category/104711>



PILOTS AND FLIGHT CREWS

- The per diem rates for cities located in foreign countries are located on the State Department's website at (the foreign rates are not tied to the US government's fiscal year):
http://aoprals.state.gov/content.asp?content_id=184&menu_id=78



PILOTS AND FLIGHT CREWS

- If the taxpayer is claiming actual expenses, rather than per diem, they must maintain records to prove their expenses and that they were related to the required travel. This may include invoices, receipts, credit card statements, etc. The actual expenses are reduced by any reimbursement, including per diems, received from the employer.



PILOTS AND FLIGHT CREWS

- Taxpayers who use the per diem method must base their deduction from the Federal per diem rates that are published by the IRS for the cities they are traveling to. In general, the per diem reimbursement paid by the airlines is less than the federal rates. Where the Federal rate for per diem is higher than the reimbursement received, this creates a deduction for the taxpayer for the difference between the reimbursement and the per diem rate.



PILOTS AND FLIGHT CREWS

- Again, the taxpayer must reduce their allowable deduction for any per diem reimbursement received from their employer. Because the per diem method does not require the taxpayer to substantiate their expenses, this method is less onerous with regards to the records that must be maintained to claim it.



PILOTS AND FLIGHT CREWS

- Whether the taxpayer uses the per diem method or the actual expense method is their choice, and the same method does not need to be used consistently throughout the tax year. However, the same method must be used for the same trip.



PILOTS AND FLIGHT CREWS

- Example: A flight attendant, works on a flight from Dallas to New York City in November 2013. He stays in NYC for two days, then flies back to Dallas on another working flight. His airline paid for his hotel in NYC, and paid him a per diem for the two days of \$60 per day.
- The federal per diem rate for M&IE in New York City is \$74. John would report the \$120 as a reimbursement, but can claim \$148 as his per diem expense.



PILOTS AND FLIGHT CREWS

- John could use the actual expense method rather than the per diem method. If John's actual expenses for meals and incidentals for the two days were \$150, he could claim a deduction for that, less his reimbursement (which would result in an actual tax deduction of \$24 [$\150 expense less $\$120$ reimbursement = $\$30 \times .80$]).



PILOTS AND FLIGHT CREWS

- Foreign Earned Income
- Flight crews who work on international flights may be able to claim the foreign earned income exclusion on the wages that they are paid while located in a foreign country, like other taxpayers who work outside of the country.



PILOTS AND FLIGHT CREWS

- However, because of the rather unique way that crew members are paid by the airlines, the amount of exclusion available may be more limited than the taxpayer thinks. Additionally, the crew member would need to show that they meet either the bona fide residence test or the physical presence test in order to claim the foreign earned income exclusion. This generally limits the exclusion to U.S. crew members who are based in foreign countries.



PILOTS AND FLIGHT CREWS

- Airline flight crews are usually paid by the airlines only for time worked on a “gate to gate” basis. What this means is that the crew does not start getting paid until the door on the aircraft closes, and they are paid until the door reopens at the other end. Essentially, as long as the aircraft door is closed the crew is getting paid, even if the plane is going nowhere and is just sitting on the tarmac.



PILOTS AND FLIGHT CREWS

- Even though they may be working both before and after that with assisting passengers, they are not being paid for that additional time. As such, their actual work time in the foreign country is limited to the time the plane is flying in that country's airspace, and for the taxiing time it takes to get to or from the gate to their takeoff or landing.



PILOTS AND FLIGHT CREWS

- The information on how much time this actually comprises is calculated by the airline and is available to the crews to calculate their foreign income.
- Where taxpayers usually get into trouble on their tax returns is attempting to claim work time over international airspace as foreign earned income. This is particularly true for flight crews who fly long distance international flights, such as from Los Angeles to Tokyo or from New York to Dubai.



PILOTS AND FLIGHT CREWS

- However, in order to exclude the income it must be attributable to time working in a foreign country, and international airspace is not a foreign country.



PILOTS AND FLIGHT CREWS

- Example: A U.S. citizen is a flight attendant for United Airlines, and is based in Sydney, Australia. She meets the bona fide residence test to exclude her foreign income on her U.S. return. Sheila works the Sydney to Los Angeles flight and return once a week. The flight is 15½ hours each way.



PILOTS AND FLIGHT CREWS

- United calculates that of the flight time, the plane is in Australian airspace for half an hour, international airspace for 14 hours, and U.S. airspace for 1 hour. The same times apply to the return trip to Sydney. Sheila can exclude 1 hour of her pay under the foreign earned income exclusion (half an hour each way), but the other 30 hours are taxable to her on her U.S. return, as they cannot be sourced to a specific country or are sourced to the U.S.



PILOTS AND FLIGHT CREWS

- Example: Assume the flight attendant is now based in Paris, France, working for Air France. She mostly works commuter flights within Europe, but about every two months she works the Paris to New York flight. Most of the income would be allocable to foreign airspace and therefore excludable; however, her flight times to and from New York would mostly not be allocable to foreign airspace (as they are flying in U.S. airspace or over international waters), except for the brief time spent in French airspace.



PILOTS AND FLIGHT CREWS

- Case Study: W. & A.M. Wilson vs. Commissioner



REAL ESTATE

- Real estate rental activities are usually passive activities by definition. One of the major exceptions to the application of the passive activities rules to rental activities is that for Real Estate Professionals or as referred to in the IRC "Taxpayers in Real Property Business."



REAL ESTATE

- Qualified real estate professionals can generally fully deduct their losses from rental real estate in which they materially participate, and are not limited by the passive activity rules.
- The Tax Reform Act of 1986 added IRC §469, which limits a taxpayer's ability to deduct losses from business activities without material participation and from rental activities.



REAL ESTATE

- The passive activity loss rules apply at the individual level (partnerships, S-Corps, etc., generally report the individual's share of the full loss on the Schedule K-1, and any adjustments are made on the individual's return) and apply to virtually every business or rental activity whether reported on Schedules C, F, or E, and not just to tax shelters per se.



REAL ESTATE

- The passive loss limitations also apply in full to personal service corporations and to closely held C Corporations, but with limited applications.
- Generally, losses generated by passive activities can only be used to offset income generated by passive activities. There are two kinds of passive activities:



REAL ESTATE

- Rentals, including equipment leasing and rental real estate; and,
- Businesses in which the taxpayer does not materially participate, including activities on Schedules C, F, and from partnerships, S-Corporations, and LLCs.



REAL ESTATE

- Generally, passive activity losses in excess of passive activity income are not deductible. However, there is a limited exception with regard to rental activities if the taxpayer actively participates. The exception is that rental real estate losses up to \$25,000 may be deducted if the modified adjusted gross income (see sidebar) is less than \$100,000.



REAL ESTATE

- The \$25,000 exception is phased out at the rate of 50 cents for every dollar of MAGI over \$100,000. Therefore, when MAGI exceeds \$150,000, the \$25,000 offset is not allowed. The phase-out is to the \$25,000 cap, not the actual loss incurred.



REAL ESTATE

- Example: Taxpayer has a rental real estate property in which he actively participated that generated a \$5,000 loss and his MAGI is \$120,000. His passive activity exception cap is reduced to \$15,000 [$\$25,000 - ((\$120,000 - \$100,000) \times 0.50)$]. Therefore, he is allowed his entire \$5,000 loss against his other income because the loss is less than or equal to the reduced cap.





REAL ESTATE

- Active participation relates only to rental real estate activities. Active participation standards are met if the taxpayer (or spouse) participates in the management of the rental property in a significant and bona fide sense. Examples of activities that demonstrate active participation include approving new tenants, deciding on rental terms, and approving expenditures.





REAL ESTATE

- Only individuals and not entities can actively participate in rental real estate activities, and the taxpayer (and/or spouse) must hold at least a 10% interest in the activity throughout the year. If the property is held by a partnership, and the individual is a limited partner, then they cannot be an active participant even if the ownership interest is 10% or greater.



REAL ESTATE

- There is an exception to the individual rule for a decedent's estate which is treated as an active participant for its tax years ending less than two years after the decedent's death if the decedent would have satisfied the active participation rule in the year the decedent died.
- Example: Married taxpayers were not entitled to the \$25,000 offset for rental real estate activities under IRC §469 for losses attributable to a condominium unit because their ownership of the unit constituted a passive activity



REAL ESTATE

- They failed to produce evidence that they exercised independent discretion and judgment regarding approval of tenants, rental terms, expenditures for repair and capital improvements, or management of the unit. The fact that the taxpayers could terminate the contract with a rental agency that performed these functions did not constitute active participation.



REAL ESTATE

- The Qualified Real Estate Professional
- The IRC §469(i) offset exception (\$25,000) and phase out (MAGI of \$100,000 to \$150,000) are not indexed for inflation and as such have remained at these values since enactment in 1994. This has made rental real estate less attractive as a tax reduction strategy.
- In addition, some taxpayers may have multiple rental properties on which the annual loss far exceeds the \$25,000 cap.



REAL ESTATE

- Congress has also created an exception to the passive activity loss rules in connection with rental real estate that allows certain individuals who earn the majority of their living through rental activities to be allowed to potentially take their real estate losses either partially or in full depending on certain elections that may be made.



REAL ESTATE

- These individuals are referred to as “Qualified Real Estate Professionals.” Since this status allows taxpayers to claim losses in the current year that would otherwise be suspended passive losses, it is not unusual to see taxpayers in audit that would not appear to qualify for this status, but have claimed it anyway in order to lower their taxable income.



REAL ESTATE

- Qualifying Tests To qualify as a real estate professional, the taxpayer must meet these 3 tests:
 - 1. Own at least one interest in rental real estate;5 and
 - 2. Spend more than one-half of their personal service time (working for income) in real property trades or businesses in which the taxpayer materially participates;
 - 3. Perform more than 750 hours of service during the tax year in real property trades or businesses in which the taxpayer materially participates.



REAL ESTATE

- Note that time spent in real estate activities by the taxpayer's spouse will count toward whether or not the taxpayer materially participated in a property (or vice versa), however, spousal hours do not count toward satisfying test 2 or 3. Also, since the tests are determined annually, it is important to realize that taxpayers may qualify for some years, but not for others.



REAL ESTATE

- Test 1: Owning an Interest in Rental Real Estate.
- Any rental real estate activity that a taxpayer has grouped with a non-RRE trade or business is not an interest in rental real estate for this exception – unless the other trade or business activity is insubstantial in relation to the rental real estate activity.



REAL ESTATE

- Test 2: Personal Services.
- Only services performed by individuals are considered personal services. Services performed as an employee, a self-employed activity, or as a partner or member in an entity unrelated to real estate is personal service time and goes to calculating the one-half of personal service time spent in real property trades or business.



REAL ESTATE

- The following services are not personal services in real property trades or businesses:
 - Providing of utilities related to real property
 - Services that are necessary solely to permit the lawful use of the property
 - Services that consist of construction of improvements, or repairs which extend the useful life to a period substantially longer for which it is usually rented.
 - Such items as trash collection, maintenance of common areas, cleaning, routine repairs, and the like that are commonly provided in connection with long term rentals of rental properties.



REAL ESTATE

- Example: Taxpayer has a full-time job as an engineer (2,080 hours per year) and he owns a rental house that incurs a tax loss of \$35,000 for the year. He earns \$180,000 from his engineering job.



REAL ESTATE

- In order to qualify as a real estate professional so that he can take the loss against his ordinary income, William would have to spend 2,081 hours or more in real property trades or businesses including the time he spent on his rental property – 2,080 in his job plus 2,081 in real property trades = $4,161 \div 2 = 2,080.5$. It is not likely that William could qualify as a real estate professional while holding down an unrelated full-time job.



REAL ESTATE

- Personal Services Performed as an Employee. Personal services performed in real property trades or business while acting as an employee are not counted toward the personal service hours in real estate trades for the benefit of the prospective RE pro, unless the person performing the services has a 5% or more ownership interest in the employer.



REAL ESTATE

- If the employee had at least a 5% ownership interest at some time during the year, then only those personal services performed during the period in which the employee had the interest are treated as being performed in a real estate trade or business.



REAL ESTATE

- Real Property Trade or Business.
- “Real property trade or business” means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.
- Lawyers, accountants, appraisers, and lenders are not involved in real property trades or businesses with regard to their personal services performed in those professions.



REAL ESTATE

- **Material Participation.** Material participation is a much more stringent standard than active participation with regard to the \$25,000 exception. Material participation is necessary for an individual to be considered a real estate professional. There is often much confusion when discussing material participation rules with taxpayers.



REAL ESTATE

- Material Participation:
 - whether the taxpayer materially participates at all, this is defined by passing one of the seven tests outlined below.
 - spending more than half of their personal service time in rental activities in which they materially participated.
 - spending more than 750 hours in the activity in which they materially participated.



REAL ESTATE

- Example: Taxpayer is semi-retired and has no W-2 income. Indeed his only “work” is maintaining the one rental property he owns, the former family house. He now lives in a retirement condo. John employs no one to help him with the rental, and keeps a log book of his time spent at the home.



REAL ESTATE

- Over the course of the year he spent an average of 10 hours per week in the activity. John meets the basic requirement of material participation (meeting at least tests 1, 2, and 3 below). John also meets the test of spending at least half of his personal service time in activities in which he materially participates, in this case the same activity. However, since he did not spend more than 750 hours in the activity (only 520) he will not qualify as a Real Estate Professional.



REAL ESTATE

- Material participation:
 - 1. The individual participated (defined below) in the activity for more than 500 hours during the year.
 - 2. The individual's participation was substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity.



REAL ESTATE

- 3. The individual participated in the activity for more than 100 hours during the tax year, and the individual's participation was at least as much as any other individual (including individuals who do not own an interest in the activity) for the year.
- 4. The activity is a significant participation activity, and the individual participated in all significant participation activities for more than 500 hours.



REAL ESTATE

- 5. The individual materially participated (any of the other tests met) in the activity for any 5 (whether or not consecutive) of the 10 immediately preceding years.
- The activity is a personal service activity in which the individual materially participated for any 3 (whether or not consecutive) preceding tax years.



REAL ESTATE

- Based on the facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during the year. This test is not met if the individual participated in the activity for 100 hours or less during the year. Managing the activity does not count for this purpose if:
 - a. Any other person received compensation for managing the business, or
 - b. Any other individual spent more hours during the tax year managing the activity regardless of whether the other individual was compensated for the management activity.



REAL ESTATE

- CAUTION: Tests #4 and #6 above do not apply to rental activities! Thus they cannot be used by a Real Estate Professional to determine which properties he or she materially participated in.



REAL ESTATE

- Significant Participation Activity: ...is any trade or business activity in which an individual participated for more than 100 hours during the year and in which the individual did not materially participate under any of the other material participation tests.



REAL ESTATE

- Example 5: An individual who had a full-time job in the field of information systems was not entitled to business expense deductions with respect to a real estate development and marketing activity because he was not engaged in a trade or business.



REAL ESTATE

- Although the taxpayer intended to make a profit, he was not regularly and actively involved in the activity, and his business operations did not commence. The expenses he incurred in the activity were, at most, startup costs and/or organizational expenses. However, he was allowed to deduct mortgage interest and real estate taxes paid with respect to the activity on Form 1040, Schedule A.



REAL ESTATE

- Participation Defined. Generally, any work done by a taxpayer in connection with an activity in which the taxpayer owns an interest is treated as participation in the activity. This general rule then looks at exceptions.



REAL ESTATE

- 1. Work not usually performed by owners - Work done in connection with an activity is not treated as participation if both of the following are true:
 - a. The work is not of a type that is customarily done by an owner of such an activity; and
 - b. One of the principal purposes for the performance of such work is to avoid the disallowance, under §469 and the regulations, of any loss or credit from such activity.



REAL ESTATE

- 2. Participation as an investor - Work done by a taxpayer as an investor is not treated as participation in the activity unless the taxpayer is directly involved in the day-to-day management or operations of the activity. Work done as an investor includes:
 - a. Studying and reviewing financial statements or reports on operations of the activity;



REAL ESTATE

- b. Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and
- c. Monitoring the finances or operations of the activity in a non-managerial capacity.
- Participation of a spouse - Participation in an activity by a taxpayer includes any participation by the taxpayer's spouse. This applies even if the spouse does not own any interest in the activity and even if the spouse did not file a joint return for the year.



REAL ESTATE

- 4. Proof of Participation - Taxpayers may use any reasonable means to prove their participation. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation can be established by other reasonable means.



REAL ESTATE

- Reasonable means may include the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. However, the IRS will likely ask for the contemporaneous daily time logs in audits.



REAL ESTATE

- Material Participation and the Real Estate Professional
- As already mentioned, a real estate professional may deduct rental real estate losses only to the extent that there was material participation in each rental activity (again note that material participation tests #4 and #6 above do not apply to rental activities).



REAL ESTATE

- Unless the taxpayer elected to group his rentals as a single activity (see Election to Combine Rental Activities below), each rental is treated as a separate activity. Under the material participation rules, the time of both spouses is counted. The material participation test then applies separately to each individual rental real estate activity.



REAL ESTATE

- If the real estate professional materially participates in an activity, net income or loss from that activity is non-passive. If they do not materially participate, despite being a real estate professional, the rental is passive and losses (or income) go on Form 8582, Passive Activity Loss Limitations.



REAL ESTATE

- In determining whether a taxpayer materially participates in a rental real estate activity, work the taxpayer performs in a management activity is taken into account only to the extent that it is performed in managing the taxpayer's own real estate. Individuals who are involved in leasing rental properties are generally considered to be engaged in a real property trade or business.



REAL ESTATE

- A taxpayer who does most of the work in a rental meets the material participation test if “The individual’s participation was substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity.”



REAL ESTATE

- However, if there is on-site management, it may be difficult to prove the taxpayer meets this test because:
 - 1. Rental activities, by nature, normally do not require significant day-to-day involvement, i.e., they are not time intensive.



REAL ESTATE

- 2. For many taxpayers using any kind of outside management, the only material participation test available is the 500-hour test, because often the other tests will not apply if outside management is present. Further, as rental activities are not in general time intensive, it is not unusual for an individual rental activity to not require 500 hours of participation. In addition, if a taxpayer has multiple rentals, then it is likely the taxpayer would not have sufficient time available to spend 500 hours on each individual rental real estate activity.



REAL ESTATE

- Example 6: A married taxpayer was denied a rental real estate loss because she was unable to convince the Tax Court that she was a real estate professional. Although she did most of the work on the 4-plex apartment building, she was employed full-time by a charity and part-time as an adjunct professor.



REAL ESTATE

- Although the taxpayer used a Palm Pilot to manage her daily activities, she only produced at trial a hand-written calendar with “estimated” rental activities indicated for a total of 774.5 hours. The court was not persuaded that this was more than a “ballpark guesstimate” of the hours.



REAL ESTATE

- Furthermore, the court found that she did not perform more than one-half of her personal services in real property trades or business because her full-time exempt salary job recorded her annual hours as 2,080. The court was not persuaded by her testimony that she only worked 8 hours a week for the charity that paid her an annual salary of \$55,000 plus benefits.



REAL ESTATE

- The court said, "The 2,080 hours Casey's payroll records show far exceed the 774-hour maximum petitioner would have been able to work and still meet the test outlined in section 469(c)(7)(B)."



REAL ESTATE

- This example clearly indicates that the court interprets IRC §469(c)(7)(B) to indicate that hours spent in the real estate trade or business is included in the total personal service time in all trades and businesses. The result is that a real estate professional must spend more than an equal amount of time in real estate trades and professions as they spend in all other trades and professions. 299



REAL ESTATE

- Example 7: A taxpayer failed to satisfy the material participation requirements of §469(c)(7) to qualify as a real estate professional and was not entitled to deduct unlimited real estate losses. The taxpayer did not offer at trial a contemporaneous written record (appointment book or calendar) to prove the number of hours he spent working on his five rental properties.



REAL ESTATE

- Rather, based on certain contemporaneous pictures, letters and receipts, the taxpayer drafted lists of tasks that he claimed to have performed with respect to each property for which he assigned roughly estimated hours.



REAL ESTATE

- Election to Group Rental Activities
- For purposes of qualifying as a real estate professional, each of the taxpayer's rental activities (separate properties) are treated as separate activities unless the taxpayer elects to treat all interests in rental real estate as a single activity.



REAL ESTATE

- A qualifying taxpayer may make an election to treat all of the interests in rental real estate as a single rental real estate activity pursuant to §469(c)(7)(A).²⁶ This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer, even if there are intervening years in which the taxpayer is not a qualifying taxpayer.



REAL ESTATE

- Any failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have an effect and the taxpayer's activities will be passive subject to the limitations and possible reporting on Form 8582 if there is a limited loss.



REAL ESTATE

- Making the Election The election to treat all interests in various rental properties as a single rental real estate activity is made by filing a statement with the taxpayer's original income tax return for the taxable year for which the election is first made.



REAL ESTATE

- This statement must include language that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section §469(c)(7)(A). The return on which the election is first made must be filed by the due date (including extensions). It is possible under certain circumstances to make a late election to group rental activities.



REAL ESTATE

- The two primary caveats are the taxpayer must have treated the properties as grouped on any return that would have been affected had the election been timely made, and that the taxpayer had “reasonable cause” for not making the election in a timely fashion.



REAL ESTATE

- Revoking the Election Once the election is made, it can be revoked only if there is a material change to the taxpayer's facts and circumstances. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation.



REAL ESTATE

- This statement must include language that the taxpayer is revoking the election under §469(c)(7)(A) and include an explanation of the nature of the material change which prompted the revocation.



REAL ESTATE

- A material change in circumstance does not include whether or not the taxpayer is better off or worse off in any given year as a result of having previously made the election; there must be more of a material change than the tax advantages having changed.
- Similarly, whether a taxpayer qualifies as a RE pro or not is not a material change in the taxpayer's facts and circumstances for purposes of this election.



REAL ESTATE

- Example 8: A taxpayer is denied a series of losses for his rental real estate activities even though he meets the test as a real estate professional. The taxpayer failed to meet the material participation test with respect to each of four rental properties and he did not make a timely election pursuant to §469(c)(7)(A) to treat the four properties as one activity.



REAL ESTATE

- The taxpayer claimed that the consolidation of his rental activities on Schedule E was sufficient to treat his interest in the rental properties as a single real estate activity for purposes of the material participation test. The court held that aggregating losses on Schedule E is insufficient notice to the IRS that they unequivocally agreed to accept the benefits and burdens of the election.



REAL ESTATE

- Disallowed Losses from Former Period of Passive Activity
- For any year in which a qualifying taxpayer materially participates in a rental real estate activity, that rental real estate activity will be treated as a former passive activity if the activity has disallowed losses from the prior year(s).
- The disallowed losses for an activity can be taken against any net income from grouped activities of which the activity is a part in the year in which the election is made.



REAL ESTATE

- Example: Taxpayer owns an interest in three rental buildings, A, B, and C. In 2015, taxpayer has disallowed passive losses of \$25,000 allocated to building A, \$10,000 allocated to building B, and \$5,000 allocated to building C.
- In 2016, taxpayer has \$5,000 of net income from building A, \$5,000 of net loss from building B, and \$10,000 of net income from building C.



REAL ESTATE

- Effective beginning in 2016, Benjamin makes the election to treat the three buildings as a single rental real estate activity. Taxpayer works full-time managing the three buildings and thus materially participates in the combined activity in 2016. Therefore, the combined activity is not a passive activity of taxpayer in 2016.



REAL ESTATE

- Moreover, as a result of the election to group the activities, the carryover unallowed loss from 2015 of \$40,000 is allocated to the combined activity in 2016. Taxpayer's net income of \$10,000 from the combined activity in 2016 is non-passive income. Under §469(f), the net income from a former passive activity may be offset with the unallowed passive loss from the same activity.



REAL ESTATE

- Because the three buildings are treated as one activity due to the election under Reg. §1.469-9(g), and the activity is a former passive activity under §469(f), Benjamin can offset the \$10,000 of net income with an equal amount of carryover passive losses, regardless of which building produced the income or losses.



REAL ESTATE

- As a result, taxpayer has \$30,000 (\$40,000 - \$10,000) of unallowed passive losses remaining from the buildings after 2016. Notice that the passive losses maintain their character as passive in subsequent years even though the activities are now non-passive.



REAL ESTATE

- Net Investment Income Tax and the Real Estate Pro
- Income from rentals is passive income, and will therefore be subject to the 3.8% Net Investment Income Tax (NIIT) if the taxpayer's income is sufficiently high to trigger the tax.



REAL ESTATE

- In order for the rental income derived by the RE Pro to not be subject to the NIIT it must both be derived from a trade or business activity within the meaning of §162, and be non-passive for purposes of §469 (where RE Pro is defined). Thus, meeting the bar to be a RE Pro may not necessarily exempt a taxpayer from paying the NIIT on the rental income.



REAL ESTATE

- In recently released final regulations, the IRS has provided a safe harbor exception for RE Pros, which is they must participate at least 500 hours in rental activities in which they materially participated in order for the income to be considered from a trade or business, and therefore exempt from the NIIT.



REAL ESTATE

- This 500- hour safe harbor will apply to each property separately, unless the taxpayer elects to group the separate activities, in which case it would apply to the group or each group separately if grouped into more than one group.



REAL ESTATE

- Audit Standards
- The status of RE Pro is often audited. This may be due to the size of some losses being claimed, or it may be that the IRS would expect taxpayers who actually make their living from rentals to show a positive cash flow (net income) and not a large negative one (net loss) from one year to the next.



REAL ESTATE

- Determining if the Taxpayer Qualifies
- The Real Estate Professional complexity is one that continually dogs tax preparers and taxpayers alike. Below is a step-by-step method to determine if someone qualifies to be a RE Pro by asking the taxpayer a series of questions.



REAL ESTATE

- Step 1: Ask “What do you do for your regular job? How many hours a week do you work in that job?”
- Because the first hurdle to becoming a RE Pro is that they should spend more than half of their time in trades or businesses (including employment) in the Real Estate trades or businesses, finding out what they do for a living is paramount.



REAL ESTATE

- If they work 30 hours a week as an engineer or flipping burgers, they need to have worked more than 30 hours a week (and be able to prove it) in real estate trades to qualify. Keep in mind that services performed as an employee in real property trades or businesses do not count unless the taxpayer is at least a 5% owner in the business.



REAL ESTATE

- Also, a real estate trade or business is one where they are in the business of development or redevelopment, construction or reconstruction, acquisition or conversion, rental, management or operation, leasing or brokerage.
- If they don't pass Step 1, STOP – THEY DO NOT QUALIFY!



REAL ESTATE

- Step 2: Ask “How many hours in total did you spend on the rental activities, including any real estate employment?”
- If the total Material Participation hours are not more than 750 hours, STOP – THEY DO NOT QUALIFY. However, it may be that the taxpayer gives you an answer that seems to qualify, but in Step 3 you determine that they do not.



REAL ESTATE

- Step 3: Ask “Tell me a little bit about each of your properties. Are there other owners? Do you have a property manager? And how many hours a year did you spend working on that property?”
- Here you are determining if the hours they spend on each property are Material Participation Hours.



REAL ESTATE

- Material Participation Hours are hours they spend on a property for which they pass one of the material participation tests. Generally, if they are the only owner, they don't have a property manager, and they do all the work, then it is a material participation property and the hours spent are Material Participation Hours (and count towards the hours needed to pass Step 1 and Step 2).



REAL ESTATE

- Step 4: You should be here only IF ALL THE FOLLOWING ARE TRUE:
 - They spent more than 50% of their personal service time (e.g. W-2 hours and SelfEmployment hours) in real estate trades or businesses.
 - The hours they used to determine this are Material Participation Hours or qualified employment hours.
 - The total Material Participation Hours + qualified employment hours is more than 750 hours.



REAL ESTATE

- Ask: “Have you made the election to treat some or all of your properties as a single entity?”
- This may change some of your prior determinations, but it is rare that a taxpayer has made this election so we save it for last.



REAL ESTATE

- If they have made the election, then all properties for which the election has been made are treated as material participation properties as long as they qualify under the material participation rules for the group as a whole. This election allows some properties that are not material participation properties to be treated as such under the theory that all of the taxpayer's properties are a single rental operation.



REAL ESTATE

- If only some of the properties are material participation properties, then the RE Pro treatment applies only to those properties. The non-material participation properties are treated under the Active Participation rules (and limited to \$25,000 of net losses, depending on AGI).



REAL ESTATE

- The great majority of Tax Court cases regarding RE Pro's are lost on one of two items:
 - The "over 50% personal services in the real property trade or business" which is 469(c)(7)(C) REAL PROPERTY TRADE OR BUSINESS. For purposes of this paragraph, the term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.



REAL ESTATE

- One of the reasons this test is so hard to meet is that to qualify for RE Pro status, the taxpayer must usually be working only in real estate. If they work 30 hours a week as a teacher, engineer, or other non-real estate related occupation, they must work more than 30 hours a week on real estate (and be able to prove that through a contemporaneous log or employment records). And these hours must be material participation hours; not all hours will qualify.



REAL ESTATE

- 2. Section 469(c)(7)(B)(ii), which states: “such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.” And the taxpayer’s log was unrealistic to reach 750 hours or was reconstructed, i.e. not contemporaneous, and not accepted.



REAL ESTATE

- Again, the taxpayer can only use material participation hours on all their properties to determine if this test has been passed, and not all hours qualify as material participation. “Investor” types of activities do not qualify toward the material participation test. And the courts have been divided on whether hours such as travel time qualify as material participation.



REAL ESTATE

- Then the “materially participates” part is 469(c)(7)(A)(ii), which uses the separate activity language for applying the material participation test, not the 750-hour test. Note again, that the 750-hour test is separate from the property by property material participation test.
- If the taxpayer materially participates on some properties, but not on others, then the hours spent working on the latter do not count toward either the 750-hour test or the 50% personal services test.



REAL ESTATE

- The “NPA” Indicator on Schedule E It is not uncommon for the initial information document request sent by an auditor regarding an audit of rental property to ask for proof of real estate professional status whenever the Schedule E, page 1, shows “NPA” (for Nonpassive Activity), or otherwise shows an allowable loss greater than \$25,000.



REAL ESTATE

- It appears many auditors forget that losses are treated as nonpassive when any rental property that the taxpayer owns is disposed of, and that any suspended losses are allowed in full that year (as well as the suspended losses on other passive rental real estate if the disposed of property generates a gain).



REAL ESTATE

- If the taxpayer has completed his or her taxes using a software program, one way to determine whether or not the taxpayer is claiming the status of RE Pro is to review the bottom of the Schedule E, page 2, line 43, which has a reconciliation statement for RE Pros.
- If this is completed, the NPA indicator is because the taxpayer is claiming to be a RE pro; if it is left blank, the NPA indicator is from the disposition of a property or is non-passive for some other reason.



REAL ESTATE

- However, in this audit situation, having Line 43 blank may not resolve the audit, if as is often the case if a rental property is disposed, the taxpayer failed to report the disposition of the rental property on Form 4797. While a blank Line 43 may resolve the RE Pro issue, failing to properly report the disposition of the property may result in additional problems in the audit, particularly if the property was lost in a foreclosure or sold in a short sale.



REAL ESTATE

- Another common problem in examinations occurs when the taxpayer has passive rental real estate losses, but also has passive income from another activity such as from a partnership, LLC, or Schedule C. Since Section 469 allows passive losses up to the amount of passive income, the Schedule E losses may exceed the allowable \$25,000 amount if other passive activities in the return are generating sufficient income.



REAL ESTATE

- This seems to confuse the IRS examiners, who automatically assume any rental real estate losses in excess of the allowable maximum are due to the taxpayer claiming to be a real estate professional.
- Case Study: M.M. Zarrinnegar & M. M. Dini v. Commissioner