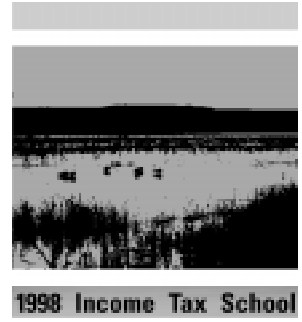
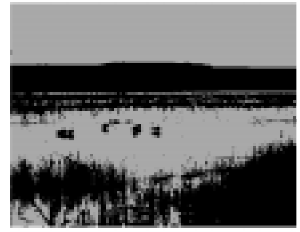


INDIVIDUAL AND SMALL BUSINESS PROBLEMS



1998 Income Tax School

INDIVIDUAL AND SMALL BUSINESS PROBLEMS

PROBLEM 1: ORIGINAL ISSUE DISCOUNT

In most situations involving OID, a Form 1099-OID will be issued to the bond holder by the issuer of the bond. In most cases, the taxpayer must report **both** the **OID interest** shown in **Box 1** and any **regular (stated) interest** shown in **Box 2** of the form 1099-OID. These two interest amounts will be reported on Schedule B.

Practitioner Caution. Any OID interest shown in Box 1 of that Form 1099-OID is properly reported on Schedule B **will increase the basis** of the bond by the OID amount. **This is very important. Failure to increase basis could result in reporting a nonexistent capital gain when the bond matures or is sold before maturity.**

Exceptions to the OID Rules. The OID rules do not apply to the following debt instruments:

1. Tax-exempt obligations such as municipal bonds (with the exception of certain stripped tax-exempt obligations)
2. Savings bonds;
3. Short-term debt instruments (those that have fixed maturity dates **not more than one year** from the date of issue)
4. Obligations issued by an individual before March 2, 1984
5. Loans between individuals, if **all of** the following are true:

   a The lender is not in the business of lending money.
   b. The amount of the loan, plus the amount of any outstanding prior loans, is $10,000 or less.
   c. Avoiding any federal tax is not one of the principal purposes of the loan.

Example 1A: Beth bought a 12% $10,000 (face value) zero coupon General Electric bond on June 1, 1993, when it was originally offered to the public. The maturity date of the bond is December 1, 1998. Beth paid the following for the bond in 1993:

Purchase price	$3,600
Brokerage transaction fee	25
Beth's basis in bond before considering OID	**$3,625**

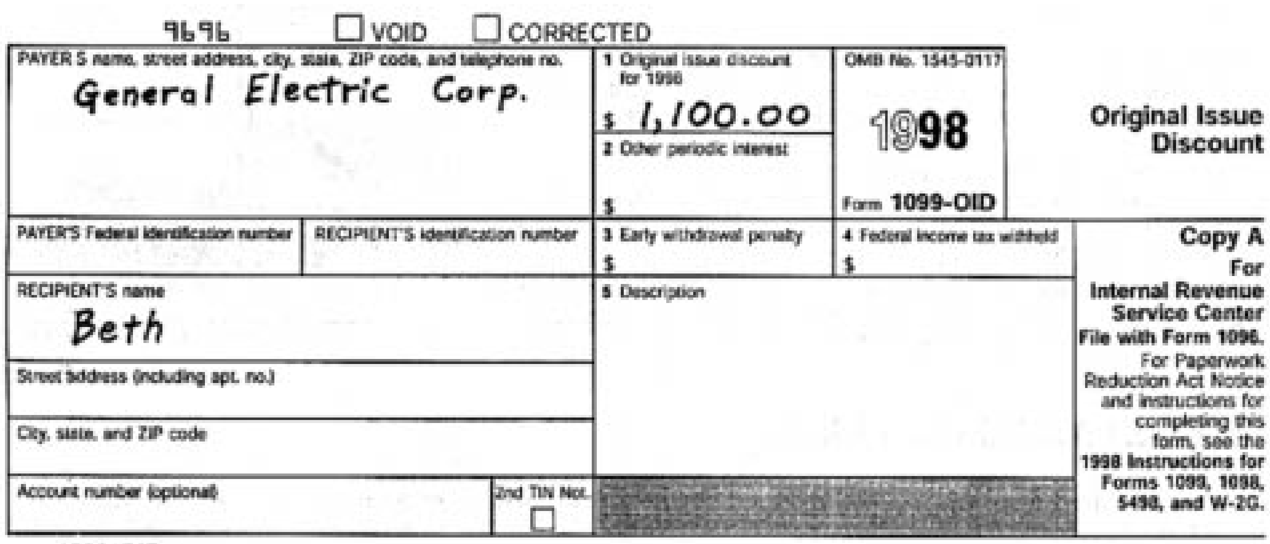
Each year, Beth receives a Form 1099-OID from General Electric. The amounts reported in Box 1 on the 1099-OIDs are shown below.

Year	Box 1 of Form 1099-OID
1993	$ 700
1994	1,200
1995	1,200
1996	1,200
1997	1,200
1998	1,100
Total	**$6,600**

The Forms 1099-OID for 1993–1998 showed no entry in Box 2, regular (stated) interest, as this is a zero-coupon bond. Each year Beth is required to report the OID amount from Box 1 of the 1099-OIDs as interest income on her Schedule B.

Question 1. How much OID must Beth report on her 1998 Schedule B?

Answer 1. $1,100, the amount shown in Box 1 on the 1998 Form 1099-OID.


9696 VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.
General Electric Corp.

1 Original issue discount for 1998
$ 1,100.00

2 Other periodic interest
$

OMB No. 1545-0117
1998
Form 1099-OID

Original Issue Discount

PAYER'S Federal identification number | RECIPIENT'S identification number

3 Early withdrawal penalty
$

4 Federal income tax withheld
$

RECIPIENT'S name
Beth

5 Description

Street address (including apt. no.)

City, state, and ZIP code

Account number (optional)

2nd TIN Not.

Copy A
For
Internal Revenue
Service Center
File with Form 1096.
For Paperwork
Reduction Act Notice
and instructions for
completing this
form, see the
1998 Instructions for
Forms 1099, 1098,
5498, and W-2G.

Question 2. What is Beth's basis in the bond for computing capital gain or loss on the 1998 Schedule D?

Answer 2. $10,225, computed as follows:

Purchase price in 1993	$ 3,600
Brokerage transaction fee	25
OID reported as interest income	6,600
Beth's basis in the GE zero-coupon bond	**$10,225**

14

Question 3. What is Beth's capital gain or loss in 1998 on the redemption (maturity) of the bond?

Answer 3. She has a $225 long-term capital **loss,** as the redemption price (face value) of $10,000 is $225 less than her $10,225 basis.

Note. Beth will receive a 1998 Form 1099-B for the $10,000 redemption amount from her broker. See Beth's completed 1998 Schedule D, which follows.

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8 GE Corp. Zero Coupon bond	6-1-93	12-1-98	10,000 00	10,225 00	<225 00>	
9 Enter your long-term totals, if any, from Schedule D-1, line 9 9						
10 Total long-term sales price amounts. Add column (d) of lines 8 and 9 . . . 10						
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 11						
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 12						
13 Capital gain distributions. See pages D-1 and D-6 13						
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1997 Capital Loss Carryover Worksheet . . . 14					( )	( )
15 Combine lines 8 through 14 in column (g) 15						
16 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f) . . . . ▶ 16					<225 00>	
Next: Go to Part III on the back.						

*28% Rate Gain or Loss includes all "collectibles gains and losses" (as defined on page D-4) and part or all of the eligible gain on qualified small business stock (see page D-4).

PROBLEM 2: CIVIL SERVICE ANNUITY

Facts. Milo retired from his job at the Social Security Administration on May 31, 1998. He began to draw his Civil Service Retirement System (CSRS) pension on June 1, 1998. Milo is married and elected to receive a 50% joint and survivor annuity. This allows his wife, Minnie, to receive half of his CSRS monthly pension if he dies first. Milo received the following 1998 Form CSA 1099R and an accompanying notice from the Office of Personnel Management.

PAID BY OFFICE OF PERSONNEL MANAGEMENT
RETIREMENT PROGRAMS
P.O. BOX 961
WASHINGTON,DC 20044-0961 52-6083699

STATEMENT OF ANNUITY PAID
Copy C - For annuitant's records. This information is being furnished to the U.S. Internal Revenue Service.
1998

Annuitant's Social Security No. 000-00-0000	11. Federal Income Tax withheld 2378.00	Gross annuity amount 22,303.33
Health Insurance Premiums 1307.15	PAID TO ➡ Milo	
Retirement Claim No. CS A8073921		
Distribution Code 1-NONDISABILITY		

State 1	State income tax withheld NONE
State 2	State income tax withheld NONE
	Original contributions 30143.00

Note
Carefully read the enclosed information

Form CSA 1099R (Rev. 1/97)
This information is being furnished to the Department of Treasury - Internal Revenue Service

To separate, tear on perforation

IMPORTANT TAX INFORMATION

CSA 1099R. Statement of Annuity Paid

General. The 1998 tax year only includes the 12 monthly annuity payments dated January 1 through December 1, 1998, as well as any adjustments made through December. It does not include the payment you received in January 1999.

Filing Instructions. Your annuity is reportable on your income tax return every year, unless your total income is below the amount required to file a return. If your total income is below that amount and you had tax withheld, you should file a return in order to get a refund. Read your IRS Form 1040 instructions carefully. Then, if you have questions, contact your local IRS office. The retirement system does not provide tax advice and does not supply IRS publications.

All annuities commencing on or after July 2, 1986, are taxable under the IRS "General Rule." For a detailed explanation of how to determine the taxable portion of your annuity, request Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits,* from the IRS. If, after reviewing Publication 721, you need assistance in determining the taxable portion of your annuity, follow the directions in Publication 721 for obtaining assistance from the IRS.

Question 1. How does Milo compute the amount of taxable CSRS pension to be reported on line 16b on the 1998 Form 1040?

Answer 1. Since Milo's annuity starting date is **after November 18, 1996,** he must use the **simplified method** to compute the tax-free monthly amount of his CSRS pension. To do this, Milo must complete the worksheet found in **IRS Publication 721,** *Tax Guide to U.S. Civil Service Retirement Benefits.* An excerpt from Publication 721 for use in preparing 1997 returns follows:.

Note: Important Change for 1998

New table of cost recovery factors for annuities with survivor benefits. If your annuity starting date is **after 1997** and your civil service annuity provides **survivor benefits for your spouse,** you must use a **new** table of cost recovery factors (the number of anticipated monthly annuity payments) to figure the tax-free part of your annuity payments under the Simplified Method. You determine the factor to use by **combining your age and your spouse's age** on the annuity starting date.

The **new** table for annuities **based on the lives of more than one annuitant** is shown below:

Combined Age of Annuitants	Number of Payments
Not more than 110	410
More than 110, but not more than 120	360
More than 120, but not more than 130	310
More than 130, but not more than 140	260
More than 140	210

Since Milo's annuity starting date was **after 1997 and since he elected a joint and survivor annuity,** he must use the new table shown above. Milo was age 63 and his wife was 62 on June 1, 1998, the annuity starting date. Therefore, the **combined age of the annuitants is 125. The figure that Milo enters on line 3 of the following Simplified Method Worksheet is 310.**

Caution. The **Simplified Method Worksheet** shown below is from IRS Publication 721 for use in preparing 1997 returns. Milo must use the new table shown above and ignore the table shown for line 3 of the worksheet.

See the completed Simplified Method Worksheet and a partially completed page 1 of Milo and Minnie's 1998 Form 1040 that follow.

Practitioner Caution. Milo's tax-free monthly amount is $97, as shown on line 4 of the worksheet. **If he lives to collect more than 310 monthly payments, he will have to include in his gross income the *full* amount of any annuity payments received after 310 payments have been made.**

If Milo does not live to collect 310 monthly payments and Minnie begins to receive them, she will also exclude $97 per month **until 310 payments (Milo's and hers) have been collected.** If she dies **before** 310 payments have been made, a **miscellaneous itemized deduction (not subject to the 2% of AGI limit) will be allowed for the unrecovered cost on her final income tax return.**

Table 1. **Simplified Method Worksheet** (Keep For Your Records)
See the instructions for the worksheet in Part II under *Simplified Method.*

1. Enter the total annuity received this year. Also add this amount to the total for Form 1040, line 16a, or Form 1040A, line 11a . . . . . $ 22,303
2. Your cost in the plan (contract) at the annuity starting date, plus any death benefit exclusion 30,143

NOTE: If you received annuity payments in prior years, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4.

3. Age at annuity starting date: Enter:

Age at annuity starting date	Enter
55 and under	360
56-60	310
61-65	260
66-70	210
71 and over	160

. 310

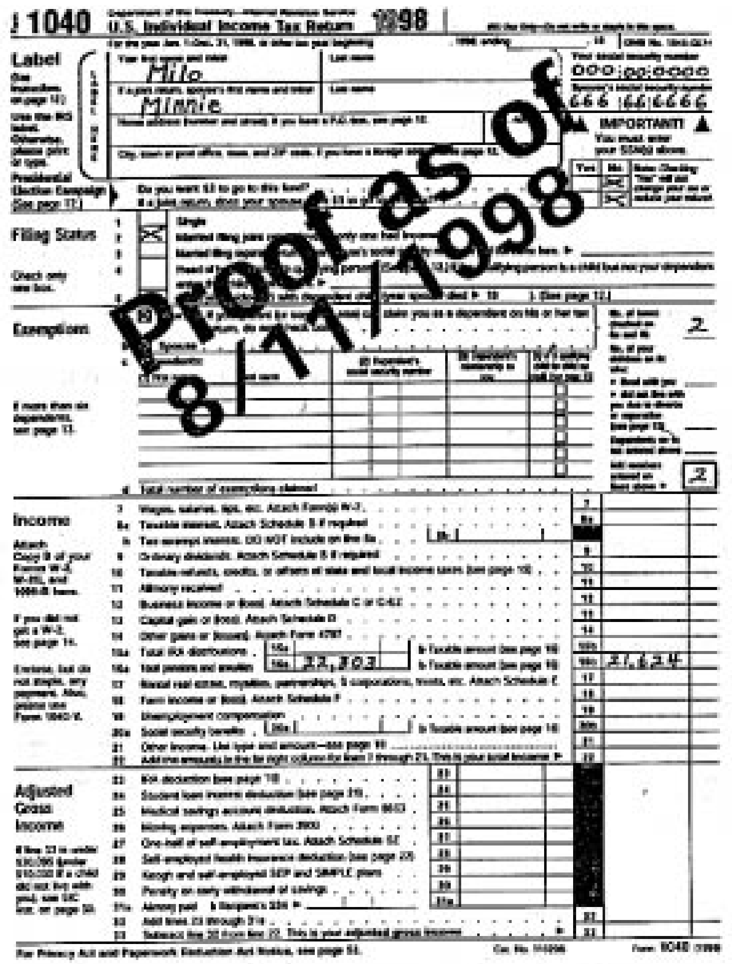
4. Divide line 2 by line 3 97
5. Multiply line 4 by the number of months for which this year's payments were made (97×7) 679

NOTE: If your annuity starting date was before 1987, enter the amount from line 5 on line 8 below. Skip lines 6, 7, 10, and 11.

6. Enter any amounts previously recovered tax free in years after 1986 0
7. Subtract line 6 from line 2 30,143
8. Enter the lesser of line 5 or line 7 679
9. Taxable annuity for year. Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 11b $ 21,624

NOTE: If your Form CSA 1099R shows a larger amount, use the amount on line 9 instead.

10. Add lines 6 and 8 679
11. Balance of cost to be recovered. Subtract line 10 from line 2 . . . . . $ 29,464


1040 U.S. Individual Income Tax Return 1998

Label

Milo

Minnie

IMPORTANT!

Filing Status

Exemptions

2

2

Income

16a 22,303

16b 21,624

Adjusted Gross Income

Proof as of 8/11/1998

PROBLEM 3: MARKET DISCOUNT BONDS

Facts. Ken bought a $30,000 (face value) 5-year U.S. Treasury bond on January 12, 1995. The bond paid an interest rate of 6.5%. It was originally issued in 1993 and had a maturity date of June 30, 1998. Due to a decline in interest rates, Ken paid only $29,198 for it, including a small transaction fee of $4. When it matured, Ken received the $30,000 face value from the Bureau of Public Debt, a U.S. Treasury agency. The $30,000 was credited to his brokerage account. Ken **did not** elect to accrue and report the market discount of $806 as Schedule B interest income on his 1995–1997 income tax returns.

Question 1. How should Ken report the maturity of the $30,000 U.S. Treasury bond on his 1998 income tax return?

Answer 1. Ken will receive a 1998 Form 1099-B from the brokerage company. The $30,000 maturity proceeds will be reported as proceeds from a security sale.

Amount reported on the 1998 Form 1099-B	$30,000
Less cost of bond:	
Purchase price of bond on Jan. 12, 1995	(29,194)
Transaction fee charged on purchase	(4)
Gain to be reported on Ken's 1998 return	**$802**

Ken bought the bond at a **market discount** and did not elect to accrue and report the $806 ($30,000 – $29,194) market discount as income currently in 1995–1997. This election is sanctioned by I.R.C. §1278(b).

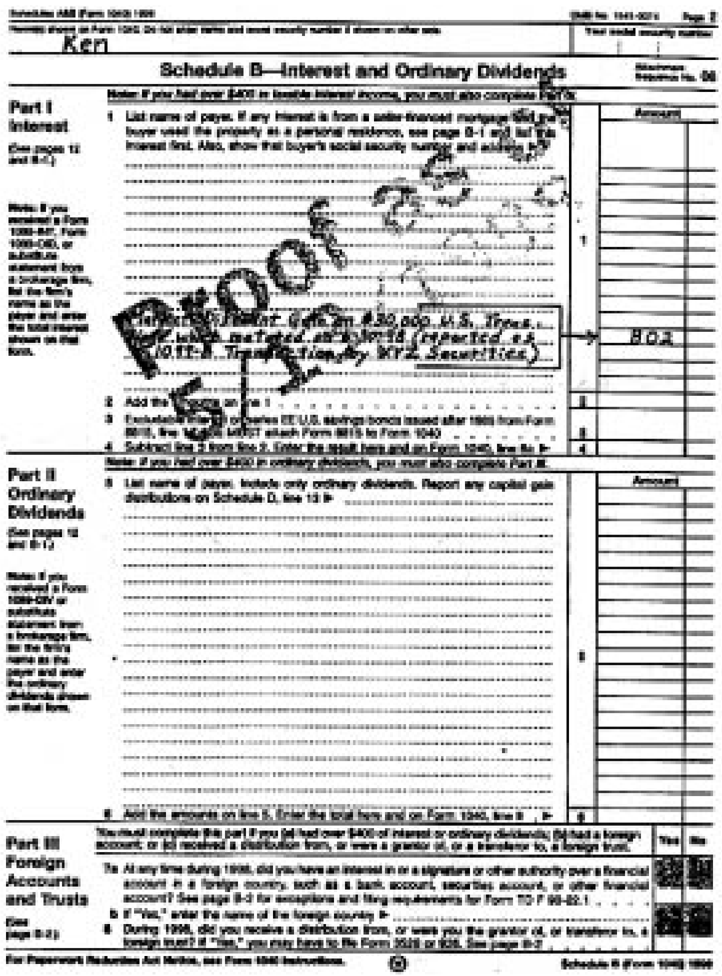
Since he bought the U.S. Treasury bond **after April 30, 1993,** Ken must report the $802 gain due to the market discount as **ordinary interest income rather than as capital gain** [I.R.C. §1276(a)(1)].

Following is an excerpt from **I.R.S. Publication 550,** *Investment Income and Expenses* (for use in preparing 1997 returns):

> If the debt instrument has market discount and you did not choose to include the discount in income as it accrued, you must report your gain on the disposition of the bond as **ordinary interest income up to the instrument's accrued market discount.**
>
> However, an exception applies if you dispose of a market discount bond that was:
>
> **1.** Issued before July 19, 1984, **and**
>
> **2.** Purchased by you before May 1, 1993.

Since the U.S. Treasury bond met neither of these requirements, Ken must use the general rule. Therefore, his entire $802 gain in 1998 must be reported as **ordinary interest income** on his 1998 Schedule B.

See Ken's partially completed 1998 Schedule B.


Ken

Schedule B—Interest and Ordinary Dividends

Part I Interest

802

Part II Ordinary Dividends

Part III Foreign Accounts and Trusts

Note. The rules discussed above apply to **both taxable** bonds such as corporate bonds and U.S. government obligations, **and tax-exempt bonds,** such as municipal bonds, **purchased after April 30, 1993.** However, there are **three exceptions** to the general rule that the amount of market discount must be reported as ordinary interest income rather than as capital gain for bonds **purchased after April 30, 1993.** Those three exceptions are

1. Bonds with a fixed maturity date of up to one year from date of issuance
2. U.S. savings bonds
3. Certain installment obligations

Tax-exempt bonds purchased before May 1, 1993, are **not** subject to the general rule requiring the reporting of market discount as ordinary interest income. Any gain on the disposition of such bonds will be treated as **capital gain.**

Taxable bonds bought before May 1, 1993, are subject to the general rule requiring the reporting of market discount as ordinary interest income **if the bond was issued after July 18, 1984.**

PROBLEM 4: ADOPTION EXPENSES

Facts. Homer and Marge Sampson commenced adoption proceedings for Brett in November 1997. Brett was born in August 1997, is a U.S. citizen, and is **not** a special-needs child. The adoption became final in September 1998.

Homer and Marge paid the following attorney fees, court costs, meals, and lodging for adoption-related expenses.

Year	Adoption Expenses Paid
1997	$2,300
1998	4,200
Total	**$6,500**

All of the $6,500 adoption-related expenses are **qualifying adoption expenses.** The Sampsons' 1998 **modified adjusted gross income** is $93,000.

Question 1. Will Homer and Marge be entitled to an adoption credit on their joint 1998 Form 1040?

Answer 1. Yes. The adoption was finalized in 1998. Since the total qualified adoption expenses they paid in 1997 and 1998 exceed $5,000, their 1998 adoption credit is limited to $5,000. This is the **maximum dollar limit** for an eligible adopted child who is **not** a special-needs child.

In addition to the dollar limit, Homer and Marge will also be affected by the **income limit,** as their 1998 modified adjusted gross income exceeds $75,000. Since their 1998 modified adjusted gross income does **not** exceed $114,999, they will be entitled to a prorated adoption credit.

See the completed 1998 Form 8839 for Homer and Marge and excerpts from IRS Publication 968, which follow.

Note. See pages 70-71 for more information concerning adoption expenses.

Form **8839**

Department of the Treasury
Internal Revenue Service

Qualified Adoption Expenses

► Attach to Form 1040 or 1040A.

► See separate instructions.

OMB No. 1545-1552

1998

Attachment Sequence No. 38

Name(s) shown on return: Homer and Marge Simpson

Your social security number

Before you begin, you need to understand the following terms. See Definitions on page 1 of the instructions.

- Eligible Child
- Employer-Provided Adoption Benefits
- Qualified Adoption Expenses

Part I Information About Your Eligible Child or Children—You must complete this part. See the instructions for details, including what to do if you need more space.

1

	(a) Child's name First	(a) Child's name Last	(b) Child's year of birth	Check if child was— (c) born before 1980 and was disabled	(d) a child with special needs	(e) a foreign child	(f) Child's identifying number
Child 1	Brett	Simpson	1997				666-66-6666
Child 2			19				

Caution: *If you received employer-provided adoption benefits, complete Part III on the back next.*

Part II Adoption Credit

Caution: If the eligible child is a foreign child, you can take the credit only if the adoption was final in or before 1998.

			Child 1	Child 2
2	Enter $5,000 ($6,000 for a child with special needs)	2	5,000 00	
3	Did you file a 1997 Form 8839? No. Enter -0-. Yes. See the instructions for the amount to enter.	3	0	
4	Subtract line 3 from line 2	4	5,000 00	
5	Enter the total qualified adoption expenses you paid in: • 1997 if the adoption was not final by the end of 1998. ✓• 1997 and 1998 if the adoption was final in 1998. • 1998 if the adoption was final before 1998.	5	6,500 00	
6	Enter the smaller of line 4 or line 5	6	5,000 00	

7	Add the amounts on line 6. If zero, skip lines 8-11, enter -0- on line 12, and go to line 13	7	5,000 00
8	Enter your modified adjusted gross income (see instructions)	8	93,000 00
9	If line 8 is $75,000 or less, skip lines 9 and 10 and enter -0- on line 11. If line 8 is over $75,000, subtract $75,000 from the amount on line 8	9	18,000 00
10	Divide line 9 by $40,000. Enter the result as a decimal (rounded to two places). Do not enter more than "1.00"	10	× .45
11	Multiply line 7 by line 10	11	2,250 00
12	Subtract line 11 from line 7	12	2,750 00
13	Enter any credit carryforward from 1997 (line 11 of your 1997 Form 8839)	13	0
14	Add lines 12 and 13. Then, see the instructions for the amount of credit to enter on Form 1040, line 45, or Form 1040A, line 30	14	2,750 00

Note: *If the credit you enter on Form 1040, line 45, or Form 1040A, line 30, is equal to the total of lines 12 and 13, stop; you do not have any credit to carry forward to 1999.*

15	1997 credit carryforward to 1999 (see instructions)	15	
16	1998 credit carryforward to 1999 (see instructions)	16	

For Paperwork Reduction Act Notice, see page 4 of instructions. Cat. No. 22843L Form 8839 (1998)

Proof as of 1/22/1998

Excerpts from IRS Pub #968 (Tax Benefits for Adoption)

Limits on the Credit or Exclusion

The credit and the exclusion for qualifying adoption expenses are each subject to a dollar limit and an income limit. These limits apply separately. The credit is also subject to a limit based on your tax liability. Figure these limits on Form 8839 (available January 1998).

Dollar Limit

The amount of your adoption credit or exclusion is limited to $5,000 for each effort to adopt an eligible child or $6,000 for each effort to adopt an eligible child with special needs. If you can take both a credit and an exclusion, this dollar limit applies separately to each. If you and another person adopt a child and both claim the credit or exclusion, this dollar limit applies to your combined credit or exclusion amounts.

The $5,000 (or $6,000) amount is the maximum amount of qualifying expenses taken into account over all taxable years. Therefore, it must be reduced by the amount of qualifying expenses taken into account in previous years for the same adoption effort.

Example 1. You are adopting an eligible child who is not a child with special needs. Your qualifying adoption expenses for the credit, before you apply the dollar limit, are $1,000 for 1998 and $6,000 for 1999. The maximum amount of expenses you can take into account for the total adoption effort is $5,000. If you take the $1,000 into account for 1998, the maximum amount of expenses you can take into account for 1999 must be reduced by the expenses you took into account for 1998. Therefore, your maximum credit for 1999 is $4,000 ($5,000 – $1,000).

Income Limit

The income limit on the adoption credit or exclusion is based on ***modified adjusted gross income (modified AGI)***. Use the following table to see if the income limit will affect your credit or exclusion.

IF your modified AGI is...	THEN the income limit...
$75,000 or less	Will not affect your credit or exclusion
$75,001 to $114,999	Will reduce your credit or exclusion
$115,000 or more	Will eliminate your credit or exclusion

When To Take the Credit or Exclusion

When you can take the adoption credit or exclusion depends on whether the eligible child is a citizen or resident of the United States (including U.S. possessions) at the time the adoption effort begins.

Child who is a U.S. citizen or resident. If the eligible child is a U.S. citizen or resident, you can take the adoption credit or exclusion even if the adoption never becomes final. Take the credit or exclusion as shown in the following table.

IF you pay qualifying expenses in...	THEN take the credit in...
• Any year before the year the adoption becomes final	The year after the year of the payment
• The year the adoption becomes final	The year the adoption becomes final
• Any year after the year the adoption becomes final	The year after the year of the payment

IF your employer pays for qualifying expenses under an adoption assistance program in...	THEN take the exclusion in...
• Any year	The year of the payment

Note: You cannot take a credit for any expenses paid before 1997. You cannot take a credit for any expenses paid after 2001, except for expenses to adopt a child with special needs. You cannot take an exclusion for any payment your employer makes after 2001.

Foreign child. If the eligible child is not a U.S. citizen or resident, you cannot take the adoption credit or exclusion unless the adoption becomes final. Take the credit or exclusion as shown in the following table.

IF you pay qualifying expenses in...	THEN take the credit in...
• Any year before the year the adoption becomes final	The year the adoption becomes final
• The year the adoption becomes final	The year the adoption becomes final
• Any year after the year the adoption becomes final	The year after the year of the payment

IF your employer pays for qualifying expenses under an adoption assistance program in...	THEN take the exclusion in...
• Any year before the year the adoption becomes final	The year the adoption becomes final
• The year the adoption becomes final	The year the adoption becomes final
• Any year after the year the adoption becomes final	The year of the payment

Note: You cannot take a credit for any expenses paid before 1997 or after 2001. You cannot take an exclusion for any payment your employer makes after 2001. You cannot take a credit or an exclusion if the adoption becomes final after 2001.

PROBLEM 5: SHORT-YEAR DEPRECIATION

Figuring Depreciation in a Short Tax Year

You cannot use the MACRS percentage tables to determine depreciation for a short tax year. If property is placed in service in a short tax year, you must first determine the depreciation for a full tax year. You do this by multiplying the basis in the property by the applicable depreciation rate. Then determine the depreciation for the short tax year. Do this by multiplying the deprecation for a full tax year by a fraction. The numerator of the fraction is the number of months (including parts of a month) the property is treated as in service during the tax year (applying the applicable convention). The denominator is 12.

Example 5A: Half-Year Convention. Tara Corporation, **with a short tax year beginning March 15 and ending December 31,** placed in service on March 16 an item of 5-year property. This 5-year property had a basis of $100. This is the only property the corporation placed in service during the short tax year. The depreciation method for this property is the 200% declining balance method. The depreciation rate is 40%, and Tara applies the **half-year convention.**

Tara treats the property as placed in service on August 1. **The law allows Tara four months of depreciation for the short tax year that consists of 10 months. The corporation first multiplies the basis ($100) by 40% (the declining balance rate) to get the depreciation for a full tax year of $40. The corporation then multiplies $40 by $^5/_{12}$ to get the short tax year depreciation of $16.67.**

Example 5B: Mid-Quarter Convention. Tara Corporation, **with a short tax year beginning March 15 and ending on December 31,** placed in service on October 16 an item of 5-year property. This property has a basis of $100. This is the only property the corporation placed in service during the short tax year. The depreciation method for this property is the 200% declining balance method. The depreciation rate is 40%. **The corporation must apply the mid-quarter convention because the property was placed in service in the last 3 months of the tax year.**

Tara treats the property as placed in service on September 1. MACRS allows Tara 4 months of depreciation for the short tax year that consists of 10 months. The corporation first multiplies the basis ($100) by 40% (the declining balance rate) to get the depreciation for a full tax year of $40. The corporation then multiplies $40 by $^4/_{12}$ to get the short tax year depreciation of $13.33.

Depreciation in Recovery Years after Short Tax Year

You can use either the **"simplified method"** or the **"allocation method"** to figure the depreciation for later tax years in the recovery period. You must use the method you choose consistently until the year of change to the straight-line method.

Simplified method. Under this method, you figure the depreciation for subsequent tax years in the recovery period by multiplying the unrecovered basis of the property at the beginning of the tax year by the applicable depreciation rate.

Example 5C: Half-Year Convention. Tara Corporation has a short tax year of 10 months, ending on December 31. It placed in service an item of 5-year property with a basis of $100. It claimed depreciation of $16.67 using a depreciation rate of 40% and the half-year convention. The unrecovered basis on January 1 of the next year is $83.33 ($100 – $16.67). Tara's depreciation for that next tax year will be 40% of $83.33, or $33.33.

Short tax year after the year the property was placed in service. If a subsequent tax year in the recovery period is a short tax year, you figure depreciation for that year by multiplying the unrecovered basis of the property at the beginning of the tax year by the applicable depreciation rate, and then by a fraction. The fraction's numerator is the number of months (including parts of a month) in the tax year. Its denominator is 12.

Allocation Method. Under this method, you figure the depreciation for each subsequent tax year by allocating to the tax year the depreciation attributable to each recovery year, or part of a recovery year, that falls within the tax year. Whether the tax year is a 12-month or short tax year, you figure the depreciation by determining which recovery years are included in the tax year. For each recovery year included, multiply the depreciation attributable to each recovery year by a fraction. The fraction's numerator is the number of months (including parts of a month) that are in both the tax year and the recovery year. Its denominator is 12. The allowable depreciation for the tax year is the sum of the depreciation figured for each recovery year.

Example 5D: Half-Year Convention. Assume the same facts as in Example 5A. Tara Corporation's second tax year is a full tax year of 12 months, beginning January 1 and ending December 31. A recovery year for the 5-year property placed in service during the short tax year extends from August 1 to July 31. Tara deducted 5 months of depreciation for the first recovery year on its short tax return. Seven months of the first recovery year and 5 months of the second recovery year fall within its second tax year. The depreciation for the second tax year will be $33.33, which is the sum of:

The depreciation for the short year, $\$40 \times {}^{7}/_{12}$ =	$23.33
The depreciation for the second tax year:	
$60 ($100 – $40) × 40%, or $\$24 \times {}^{5}/_{12}$ =	10.00
Total	**$33.33**

PROBLEM 6: INVESTMENT INTEREST—WHEN IT IS AND WHEN IT IS NOT

Investment Interest

If a taxpayer borrows money that is used to acquire property he or she holds for investment, the interest paid on the loan is investment interest. Investment interest can be deducted up to an amount equal to investment income. However, **interest incurred to produce tax-exempt income cannot be deducted.** Nor can interest expenses on straddles be deducted.

Investment interest does not include any qualified home mortgage interest or any interest taken into account in computing income or loss from a passive activity.

Allocation of Interest Expense

If the money that is borrowed is used for business or personal purposes as well as for investment, the debt must be allocated among those purposes. Only the interest expense on the part of that debt used for investment purposes is treated as investment interest. The allocation is not affected by the use of property that secures the debt. However, fully deductible home mortgage interest is not treated as investment interest, and the debt does not have to be allocated, regardless of how the proceeds are used.

Example 6A: Barry Bonds borrows $10,000 and uses $8,000 to purchase stock. He uses the other $2,000 to purchase items for his home. Since 80% of the debt is used for, and allocated to, investment purposes, 80% of the interest on that debt is investment interest. The other 20% is nondeductible personal interest.

Debt proceeds received in cash. Interest paid on debt proceeds that the taxpayer received in cash is generally treated as nondeductible personal interest. However, the taxpayer can treat any payment made within 30 days before or after the taxpayer received the proceeds as made from those proceeds. This applies to any payment (up to the amount of the proceeds) made from any account the taxpayer owns, or from cash. Also, the taxpayer can treat the payment as made on the date the taxpayer received the cash instead of on the date he or she actually made the payment.

Debt proceeds deposited in account. If a taxpayer deposits debt proceeds in an account, that deposit is treated as an investment expenditure. Amounts held in the account are treated as investment property, regardless of whether the account bears interest. Any interest paid on the deposited proceeds is investment interest. But, if the taxpayer withdraws the funds and uses them for another purpose, the debt and any interest paid must be reallocated.

Example 6B: Assume in Example 6A that Barry borrowed the money on March 1 and immediately purchased the stock for $8,000. He did not purchase the household items until June 1. He had deposited the $2,000 in the bank. He had no other transactions on the bank account and made no principal payments on the debt. The $2,000 is treated as being used for an investment purpose for the 3-month period. His total interest expense for 3 months on this debt is investment interest. In June, he must begin to allocate 80% of the debt and the interest expense for investment purposes and 20% for personal purposes.

Payments on debt require new allocation. As a taxpayer repays the debt, he or she must reallocate the balance. The amount allocated for personal purposes by the repayment must be reduced first. Then reallocate the balance of the debt to find what portion is for investment purposes.

Example 6C: If, in Example 6B, Barry repays $500 on November 1, the entire repayment is applied against the amount allocated for personal purposes. The debt balance is now allocated as $8,000 for investment purposes and $1,500 for personal purposes. Until the next reallocation is necessary, 84% ($8,000/$9,500) of the debt and the interest expense is allocated for investment.

Pass-through entities. If a taxpayer uses borrowed funds to purchase an interest in a partnership or S corporation, the interest on those funds has to be allocated based on the assets of the entity. If a taxpayer contributes to the capital of the entity, you can make the allocation using any reasonable method.

PROBLEM 7: OUTSIDE BASIS IN S CORPORATIONS

A shareholder's basis in the corporation's stock (called outside basis) is perhaps the most important concept to grasp in order to understand S corporations. Shareholder-employee basis governs the ability both to deduct losses and to receive tax-free distributions.

A. RELATIONSHIP OF BASIS TO LOSSES

The fact that the S corporation passes losses to shareholders does not guarantee that the shareholder can deduct them. In order for a loss to be deductible by the shareholder, the loss must not exceed the shareholder's basis in his or her stock in the corporation plus certain debt basis [§1366(d)(1)]. Any loss that is deductible in a given year reduces the shareholder's basis at the close of that year. Basis cannot be reduced below zero.

Any loss not deductible by operation of the basis limit is carried forward to the next taxable year [§1366(d)(2)]. It may be deducted when the shareholder gains sufficient basis to absorb it.

B. STOCK BASIS DEFINED

- Stock basis presents no particularly difficult interpretive problems.

- The shareholder finds a starting point, or initial basis, at the time of acquisition.
- The shareholder then adjusts his or her basis each year for his or her share of the corporation's income, deductions, and losses, and reduces basis for distributions received (other than dividends from accumulated earnings and profits).
- See the 1995 edition of *Farm Income Tax Book*, pp. 573–576.

C. DEBT BASIS DEFINED

- Debt basis is considerably more complicated than stock basis.
- In addition to the annual adjustments, there is a question of what constitutes valid debt basis.
- In general, basis includes only direct loans from a shareholder to the corporation, and does not include corporate debt to other parties, even if a shareholder has guaranteed or co-signed the loan.
- Debt basis is frequently litigated.
- See the 1995 edition of *Farm Income Tax Book*, pp. 578–582. Also see pp. 576–578, for examples of adjustments to debt basis.

D. BASIS AT TIME OF ACQUISITION

Subchapter S provides few special rules for the starting point of basis calculations. Instead, the taxpayer must look to other provisions, which depend on how and when the stock (or debt) was initially acquired.

- If the stock and debt were received in a §351 incorporation, there is a substituted basis from the property given to the corporation (§358).
- If the shareholder purchased the stock (and debt), the initial basis is cost. It may have no relation to the book value on the corporate records (§1012).
- If the stock was received through an estate, the basis is fair market value on the date of the decedent's death or on the alternate valuation date (§1014).
- If the stock was received as a gift, it is important to know the date of the gift, the donor's basis, and the fair market value on the date of the gift (§1015).
  - If the gift was prior to 1977, the holder's basis is the donor's basis increased by any gift tax, limited to fair market value on the date of the gift.
  - If the gift was after 1976, the holder's basis is the donor's basis increased by gift tax, limited to gift tax attributable to appreciation in hands of donor.
  - If the fair market value of the stock was less than the donor's basis, there is a special loss limit. The starting point for any loss determination is the fair market value at the date of the gift.
- Stock received as compensation is its imputed cost, or gross income reported by the shareholder, in addition to any amount that the recipient paid for his or her shares [Treas. Reg. §1.83-4(b)]. This principle was applied to S corporation stock in PLR 8752006.

> For persons receiving stock due to the death of a shareholder after August 20, 1996, there is a new rule. The new shareholder (estate or other successor in interest) must reduce basis in the stock for any income in respect of a decedent in the corporation at the time of the first shareholder's death [§1367(b)(4)(B), as added by the Small Business Job Protection Act of 1996].

Note: The most commonly encountered items of income in respect of a decedent are accounts receivable of a cash method taxpayer and deferred gains on installment receivables. The effect of the new rule is that shareholders who receive stock by inheritance or bequest will need to reduce basis for their portions of these receivables. This new rule has no effect on the reporting of the S corporation's income. These items have flowed through to shareholders in the past in the same manner.

Example 7A: Julie inherits one-third of the stock in Jayco, a cash method S corporation, from her father, Jake. The fair market value of this stock at the date of Jake's death is $1,000,000. There is also $450,000 of accounts receivable at the date of Jake's death. If Jake died on or before August 20, 1996, Julie's basis would be $1,000,000. If Jake died after August 20, 1996, Julie's basis would be $850,000 ($450,000/3 = $150,000 reduction).

E. ADJUSTMENTS TO BASIS

- Each year, every shareholder will adjust his or her stock basis for the allocable portion of income and losses.
- When there is more than one shareholder, the corporation must allocate each item of income or loss on a per-day, per-share basis.
- This allocation formula holds even when there is a change in shareholdings, unless the corporation opts to split the year, as discussed below.

Example 7B: Threeco, an S corporation, had three shareholders in 1998. Teresa owned 100 shares all year. Uriah owned 100 shares from January 1 through March 14. Vinnie bought Uriah's shares and owned them from March 15 through the end of the year. During 1998 the corporation had $100,000 of ordinary income, had $20,000 of long-term capital gains, and made a charitable contribution of $10,000. It also received $12,000 of tax-exempt interest income and paid $3,600 of premiums on key employee life insurance. Each of these three items would be allocated to the shareholders as follows:

$$\text{Teresa:} \quad (100/200) \times (365/365) = 50\%$$

$$\text{Uriah:} \quad (100/200) \times (73/365) = 10\%$$

$$\text{Vinnie:} \quad (100/200) \times (219/365) = 40\%$$

Thus the allocations to each shareholder would be:

	Teresa	Uriah	Vinnie	Total
Ordinary income	$50,000	$10,000	$40,000	$100,000
Long-term capital gain	10,000	2,000	8,000	20,000
Charitable contributions	(5,000)	(1,000)	(4,000)	(10,000)
Tax-exempt income	6,000	1,200	4,800	12,000
Insurance premium	(1,800)	(450)	(1,350)	(3,600)
Total	$59,200	$11,750	$47,450	$118,400

Each shareholder would include the applicable information from above on his or her personal tax return for 1998, as follows:

Item	Schedule on Form 1040
Ordinary income	E
Long-term capital gain	D
Charitable contributions	A (if itemizing deductions)
Tax-exempt income	Page 1, for information only
Insurance premium	Not applicable

Each shareholder would adjust his or her basis for 1998 by the amount of all of these items. Thus Teresa would increase her basis by $59,200 from January 1, 1998, to December 31, 1998. Uriah would increase his basis by $11,750, from January 1, 1998, until the date of sale, March 14. Vinnie would adjust his initial basis upward by $47,450 on December 31, 1998.

F. EFFECT OF DISTRIBUTIONS

In general, distributions received by a shareholder are reductions to that shareholder's stock basis. **There are two important exceptions:**

1. After the corporation's accumulated adjustments account (AAA) is exhausted, any distribution from accumulated earnings and profits is ordinary income to the shareholder and has no effect on the shareholder's stock basis.
2. A distribution from any source other than the corporation's accumulated earnings and profits is treated as a gain to the shareholder if the distribution exceeds the shareholder's basis.

Example 7C: Cashco, an S corporation, has one shareholder, John. At the beginning of 1997, John's basis was $50,000. Cashco has $10,000 of accumulated earnings and profits and $20,000 of AAA at the beginning of 1998.

In 1998 Cashco has taxable income of $40,000 and tax-exempt income of $7,000. It makes a distribution of $135,000 to John. The effects of the year's activities on shareholder income and basis and the corporation's AAA are as follows:

	Shareholder		Corporation	
Item	Income	Basis	AAA	AEP
Beginning balance	$ 0	$ 50,000	$ 20,000	$ 10,000
1997 taxable income	40,000	40,000	40,000	
1997 exempt income	0	7,000	0	
Distribution	38,000*	(97,000)	(60,000)	(10,000)
Ending balance	$ 78,000	$ 0	$ 0	$ 0

*10,000 of dividend income and $28,000 of gain, computed as follows:

From AAA and basis	$ 60,000
Dividend from AEP	10,000
Remainder of basis	37,000
Gain	28,000
Total distribution	$ 135,000

G. SPECIAL RULES FOR LOSS YEARS

The Small Business Job Protection Act of 1996 changed the ordering rules for years in which there are both losses and distributions.

- For years beginning prior to 1997, losses were applied to reduce basis before distributions.
- The order is reversed for taxable years beginning after 1996.

Example 7D: Jayco is an S corporation with one shareholder. Assume that the shareholder's stock basis at the beginning of the current year was $110,000. In the current year the corporation sustained a loss of $60,000 and made a distribution of $70,000 to its shareholder. The corporation has no earnings and profits.

If the current year is 1996, or any earlier year, the shareholder would treat the loss and distribution as follows:

	Distributions	Basis
Basis at beginning of year		$110,000
Step 1: Add any current year income items		0
Step 2: Reduce for current year's losses		(60,000)
Basis before distributions		$50,000
Distributions		
Amount that does not exceed basis (tax-free to shareholder-reduces stock basis)	$50,000	(50,000)
Amount that exceeds basis (treat as taxable gain)	20,000	
Final basis.		**0**
Total distributions.	**$70,000**	

For all taxable years beginning after 1996, the law now provides that distributions be treated as reductions of basis before losses. Note that this coordinates with the new AAA rules discussed above.

Example 7E: Refer to Example 7D. Assume the same facts except that the current year is 1997 or later. The shareholder would treat the loss and distribution as follows:

	Distributions	Basis
Basis at beginning of year		$110,000
Step 1: Add any current year income items		0
Step 2: Reduce for current year's distributions		(70,000)
Basis before losses		$40,000
Losses		
Amount that does not exceed basis (potentially deductible in current year-reduces stock basis)	$40,000	(40,000)
Amount that exceeds basis (carryforward) (treat as taxable gain)	20,000	
Final basis.		**0**
Total distributions.	**$60,000**	

In some cases the change in ordering will make little difference, especially in a loss year. In a subsequent year, however, there could be significant tax savings from the change in the law.

Example 7F: Refer to Example 7D and 7E. Assume that in the next year the corporation has $50,000 of income and made no distributions. The treatment under each rule is compared below:

If Loss Year Was:	Before 1997	After 1996
Basis at beginning of subsequent year	$ 0	$ 0
Add income items	50,000	50,000
Less loss suspended from prior year	(0)	(20,000)
Ending basis	$ 50,000	$ 30,000
Taxable income for year	$ 50,000	$ 30,000

H. STOCK AND DEBT BASIS ADJUSTMENTS

As long as a shareholder's portion of the corporation's losses do not exceed his or her stock basis, there will never be an adjustment to debt basis. If, however, the shareholder's portion of losses exceeds stock basis, he or she must adjust debt basis as follows:

1. In the year of the loss, after the stock basis is reduced to zero, the shareholder will reduce debt basis.
2. In a subsequent year when the corporation has income, the shareholder will restore debt basis before adding any income to stock basis.

Example 7G: Updown, Inc., is an S corporation. In 1998 the corporation sustains a loss of $100,000. In 1998 Updown reports income of $140,000. At the beginning of 1997 the sole shareholder has stock basis of $60,000 and debt basis of $50,000. The shareholder will make basis adjustments in the following order:

	Stock	Debt	Total
1997 beginning	$ 60,000	$50,000	$110,000
1997 loss—reduce:			
Stock basis (not below zero)	(60,000)		(60,000)
Debt basis (not below zero)		(40,000)	(40,000)
1997 ending	$ 0	$10,000	$10,000
1998 income—increase:			
Debt basis (not above original)		40,000	40,000
Stock basis (all remaining)	100,000		100,000
1998 ending	$100,000	$50,000	$150,000

I. ORDERING RULES

A shareholder must reduce basis for deductible and nondeductible expenses and losses. As long as there is sufficient basis to absorb both types of reductions, the ordering is unimportant.

Example 7H: Dissco, Inc., an S corporation, has one shareholder, Diana. At the beginning of 1998 Diana's basis is $50,000. During 1998 Dissco sustains an ordinary loss of $40,000 and has nondeductible life insurance premiums of $5,000. Diana will reduce her basis by $45,000, to $5,000. She will be able to deduct $40,000 of ordinary loss, assuming that the loss meets the other tests for deductibility. She will receive no tax benefit for the insurance premiums.

When the total of nondeductible and deductible items exceeds the shareholder's basis, the ordering can become quite important. If the shareholder must reduce basis for nondeductible items first, it will limit the amount of potentially deductible losses in the current year.

Example 7I: Refer to Example 7H. Assume the same facts, except that Diana's basis in her stock was only $30,000 at the beginning of 1998. If she must reduce basis by the nondeductible items first, she will have only $25,000 basis remaining to claim her deduction for the ordinary loss. If she need not reduce basis for the nondeductible items, she will be able to claim $30,000 of the deductible loss in the current year.

The Internal Revenue Code is silent on the point. The IRS, however, requires that shareholders generally reduce basis for nondeductible items first [**Treas. Reg.** §1.1367-1(f)(1)]. The IRS does allow any shareholder to make an irrevocable election to reduce basis for nondeductible items after taking the deductible losses and expenses into account [**Treas. Reg.** §11367-1(f)(2)]. The price to be paid for the elective rule is that the shareholder agrees to carry forward nay nondeductible losses in excess of basis and treat them as basis reductions in the future. Otherwise, there is no requirement to carry forward a nondeductible loss or expense.

Practitioner Note. In general, shareholders will benefit from the elective ordering rule, claiming their deductible losses before they run out of basis. On occasion, however, a shareholder may benefit from the general ordering rule. This is most likely to occur when the nondeductible items are extremely large in relation to the shareholder's basis.

PROBLEM 8: HOUSEHOLD WORKERS

Who Is a Household Employee?

Some examples of workers who may be household employees are

- Babysitters
- Caretakers
- Cooks
- Drivers
- Gardeners
- Governesses
- Housekeepers
- Maids

Note: If a worker performs household services in or around the taxpayer's home that are subject to the taxpayer's will and control as to both what must be done and how it must be done, that worker is a household employee.

Who Is Not a Household Employee?

People who work for the taxpayer's trade or business are not household employees. Workers who follow an independent trade, business, or profession in which they offer their services to the general public are generally not household employees.

Examples

1. Your client, Joe, pays John Peters to care for his lawn. John offers lawn care services to homeowners in Joe's neighborhood. He provides his own tools and hires and pays helpers as he wishes. Neither John nor his helpers are Joe's household employees.

2. Gardeners, carpenters, plumbers, and painters are generally independent contractors if the facts are similar to those for John Peters (above).
3. Private secretaries, tutors, fitness advisors, and private athletic coaches would not be defined as household employees.

Example 8A: John and Jane Doe employ Sue Wonder, age 22, as a household employee. She was paid $3,000 for 1998. They employ no other individuals. Sue is paid weekly and worked 48 weeks during 1998. John and Jane withheld Sue's portion of the FICA tax ($229.50) and tax withholding of $229.00.

SCHEDULE H (Form 1040)

Department of the Treasury Internal Revenue Service

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

► Attach to Form 1040, 1040NR, 1040NR-EZ, 1040-SS, or 1041.

► See separate instructions.

OMB No. 1545-0074

1998

Attachment Sequence No. 44

Name of employer: John and Jane Doe

Social security number: 001 44 1040

Employer identification number: 39 1040444

Caution: *The $1,100 per year test applies only to Question A. The $1,000 per quarter test applies only to Question C and line 9.*

A Did you pay any one household employee cash wages of $1,100 or more in 1998? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions on page 3 before you answer this question.)

- ☒ **Yes.** Skip lines B and C and go to line 1.
- ☐ **No.** Go to line B.

B Did you withhold federal income tax during 1998 for any household employee?

- ☐ **Yes.** Skip line C and go to line 5.
- ☐ **No.** Go to line C.

C Did you pay **total cash wages** of $1,000 or more in any calendar quarter of 1997 or 1998 to household employees? (Do not count cash wages paid in 1997 or 1998 to your spouse, your child under age 21, or your parent.)

- ☐ **No.** Stop. Do not file this schedule.
- ☐ **Yes.** Skip lines 1-9 and go to line 10 on the back.

Part I Social Security, Medicare, and Income Taxes

1	Total cash wages subject to social security taxes (see page 3)	1 3,000	
2	Social security taxes. Multiply line 1 by 12.4% (.124)	2	372
3	Total cash wages subject to Medicare taxes (see page 3)	3 3,000	
4	Medicare taxes. Multiply line 3 by 2.9% (.029)	4	87
5	Federal income tax withheld, if any	5	229
6	Add lines 2, 4, and 5	6	688
7	Advance earned income credit (EIC) payments, if any	7	0
8	**Total social security, Medicare, and income taxes.** Subtract line 7 from line 6	8	688

9 Did you pay **total cash wages** of $1,000 or more in any calendar quarter of 1997 or 1998 to household employees? (Do not count cash wages paid in 1997 or 1998 to your spouse, your child under age 21, or your parent.)

- ☒ **No.** **Stop.** Enter the amount from line 8 above on Form 1040, line 55. If you are not required to file Form 1040, see the line 9 instructions on page 4.
- ☐ **Yes.** Go to line 10 on the back.

Form 1040 – Page 2

53	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required	53	
54	Advance earned income credit payments from Form(s) W-2	54	
55	Household employment taxes. Attach Schedule H	55	688
56	Add lines 49 through 55. This is your total tax ▶	56	

Note: Estimated tax penalties will not apply to underpayments of estimated tax due to employment taxes reported with Form 1040 through 1997. Beginning in 1998, estimated tax penalties may apply.

a Control number 22222	Void ☐	For Official Use Only ▶ OMB No. 1545-0008
b Employer identification number 39-104044	1 Wages, tips, other compensation 3000.00	2 Federal income tax withheld 229.00
c Employer's name, address, and ZIP code John and Jane Doe	3 Social security wages 3000.00	4 Social security tax withheld 186.00
	5 Medicare wages and tips 3000.00	6 Medicare tax withheld 43.50
	7 Social security tips	8 Allocated tips
d Employee's social security number 001-44-1040	9 Advance EIC payment	10 Dependent care benefits
e Employee's name (first, middle initial, last) Sue S. Wender	11 Nonqualified plans	12 Benefits included in box 1
	13 See instrs. for box 13	14 Other
f Employee's address and ZIP code	15 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ Deferred compensation ☐	

16 State	Employer's state I.D. no.	17 State wages, tips, etc.	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax
IL		3000,00	90.00			

Form **W-2** Wage and Tax Statement **1998**

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are **Not** acceptable.

Cat. No. 10134D

Note: Employers are not required to withhold income tax from the wages paid to a household worker. However, employees can elect to have income tax withheld if the employer agrees. The employer can pay the FICA tax for the household employee. This results in additional wage income but does not increase FICA wages. (See the example [8 B] that follows.)

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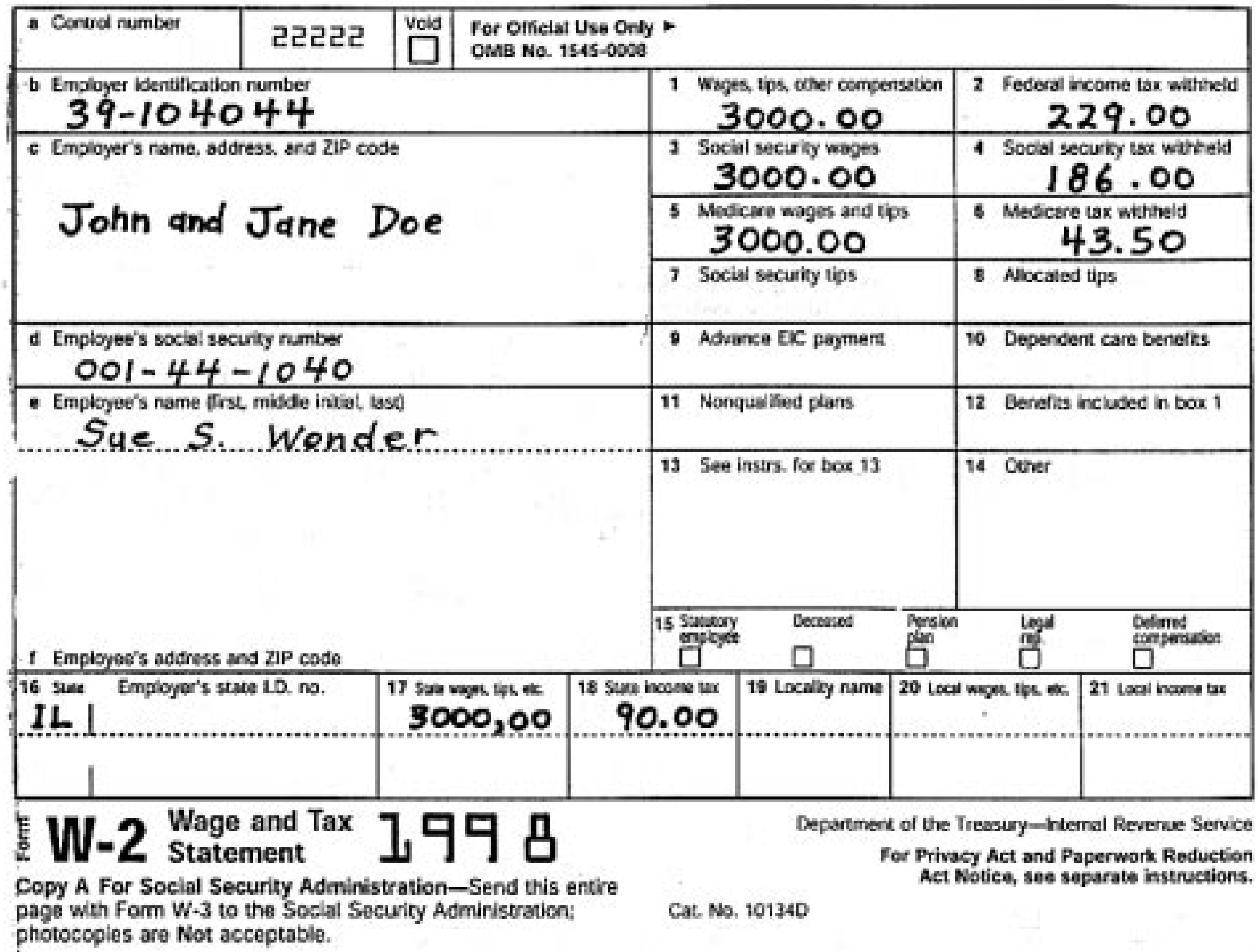
Example 8B: John and Jane Doe do not withhold Sue's share of the FICA tax. Prepare Sue's Form W-2.



a Control number	22222	Void ☐ For Official Use Only ► OMB No. 1545-0008
b Employer identification number 39-104044	1 Wages, tips, other compensation 3000.00	2 Federal income tax withheld 229.00
c Employer's name, address, and ZIP code John and Jane Doe	3 Social security wages 3000.00	4 Social security tax withheld 186.00
	5 Medicare wages and tips 3000.00	6 Medicare tax withheld 43.50
	7 Social security tips	8 Allocated tips
d Employee's social security number 001-44-1040	9 Advance EIC payment	10 Dependent care benefits
e Employee's name (first, middle initial, last) Sue S. Wender	11 Nonqualified plans	12 Benefits included in box 1
	13 See instrs. for box 13	14 Other
f Employee's address and ZIP code	15 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ Deferred compensation ☐	

16 State	Employer's state I.D. no.	17 State wages, tips, etc.	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax
IL		3000,00	90.00			

Form **W-2** Wage and Tax Statement 1998

Department of the Treasury—Internal Revenue Service

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are Not acceptable.

Cat. No. 10134D

Question 1. Jane and John Doe paid a household worker $900 during 1998. What is their tax liability and reporting requirement?

Answer 1. None. The Social Security Reform Act of 1994 **exempts** from FICA tax and reporting requirements payments to a household worker **if the total wages for the year do not exceed $1,000.**

The act states that household workers under the age of 18 are exempt from social security taxation and coverage regardless of how much they are paid during the year, unless their principal occupation is household employment.

Example 8C: The wages of a 17-year-old student who also babysits will be exempt from the reporting and payment requirements, regardless of the amount of wages earned. (In this case, the $1,000 wage threshold is negated because the employee is under age 18 and babysits as a sideline.)

Example 8D: The wages of a 17-year-old mother who leaves school and goes to work as a domestic to support her family will be subject to the reporting and payment requirements, if the amount of wages earned is $1,000 or more per year. (In this case, the "under age 18" provision is negated because the employee's regular occupation is domestic work.)

Question 2. Jane and John Doe paid two household workers $900 each during 1998. Are they both exempt from FICA tax?

Answer 2. Yes. The $1,000 threshold test is applied to each household employee.

Federal Unemployment (FUTA) Tax

Most employers pay both state and federal unemployment tax. However, even if the taxpayer is exempt from the state tax, there may still be a federal tax. **It should not be withheld from the employee's wages.**

FUTA Tax Rate. The FUTA tax rate is 6.2% of wages subject to FUTA tax. However, a taxpayer may be able to take a credit of up to 5.4% against this tax for making any required payments to the state unemployment fund by the due date for filing the Form 1040. Therefore, the tax rate may be as low as 0.8%.

The credit for payments made to the state after the due date for filing Form 1040 cannot be more than 90% of the amount that would have been allowable if the taxpayer had paid the state tax by the due date.

Note: The 5.4% credit is reduced for wages paid in a credit reduction state. **If the state of the taxpayer is subject to a credit reduction for 1998, the state's name and the amount of the credit reduction will be shown in the instructions for Schedule H, Form 1040.**

Wages Exempt from FUTA Tax. FUTA tax does not apply to wages paid in 1998 for household services performed in or around the home by the taxpayer's:

1. Spouse
2. Son or daughter under age 21
3. Mother or father

Wages Subject to FUTA Tax. FUTA tax applies to the first $7,000 of cash wages paid in 1998 to each of the taxpayer's household employees if, as a household employer, the taxpayer meets the $1,000 FUTA test. Do not count wages exempt from tax, discussed earlier, when applying the $1,000 FUTA test or figuring wages subject to FUTA tax.

$1,000 FUTA test. FUTA tax applies only if the employer paid $1,000 or more in cash wages to household employees in any calendar quarter this year or last year (1997 or 1998).

Note: This test is different from the $1,000 test for wages subject to social security and Medicare taxes. A taxpayer that meets the $1,000 FUTA test may have to pay FUTA tax on wages that are not subject to social security and Medicare taxes.

Reporting and Paying FUTA Tax. Generally, FUTA tax on wages paid to household employees in 1998 is reported and paid using Form 1040 (Schedule H).

If the state is not a credit reduction state for 1998 and the taxpayer is exempt from or has made correct and timely payments of state unemployment taxes, the total FUTA tax will simply be the result of multiplying the wages subject to FUTA by 0.008.

PROBLEM 9: RAMIFICATIONS OF PUTTING CHILD'S NAME ON BANK ACCOUNTS

Note: Parents should consider the ramifications for income taxes, gift taxes, estate taxes, and the ability of the IRS to levy on the account before putting a child's name on a bank account.

If a parent creates a joint bank account for himself or herself and a child (or a similar kind of ownership by which the parent can get back the entire fund without the child's consent), the parent has made a gift to the child **when the child draws on the account for his or her own benefit.** The amount of the gift is the amount that the child took out without any obligation to repay his or her parent.

Income Taxes

Interest earned on a joint bank account is taxed to the co-owners in proportion to their contributions to the account. **Therefore, if a parent deposits money into an account for the parent and a child, all of the interest is taxed to the parent, as explained in the following example.**

Example 9A: Margaret put $20,000 into a bank account and named herself and her son Matt as joint owners. Either has the right to withdraw money from the account without the other's consent. In 1998 the bank paid $500 of interest on the account. Margaret should report all of the $500 interest as income on her 1998 tax return.

If both co-owners contribute money to an account, the interest must be apportioned between them according to their ownership. See the following example.

Example 9B: If Margaret put $16,000 into the account and Matt put $4,000 into the account, Margaret should report $\$16,000 \div \$20,000 \times \$500 = \$400$ of the interest as her 1998 income and Matt should report $\$4,000 \div \$20,000 \times \$500 = \$100$ of the interest as his 1998 income.

Gift Taxes

Since there is no gift until one co-owner withdraws more than his or her share of the account, there are no gift tax consequences until that time

Example 9C: When Margaret puts $20,000 into the account, nothing needs to be reported on a gift tax return. If Matt withdraws $11,000 without an obligation to repay Margaret, Margaret must file a gift tax return to report the $11,000 gift. The first $10,000 of the gift qualifies for the annual exclusion, so only $1,000 is a taxable gift. Margaret does not have to pay gift taxes if she has not used up her applicable exclusion amount ($625,000 in 1998, $1 million in 2006), but she does reduce her applicable exclusion amount by $1,000.

> **Practitioner Note.** The $10,000 annual exclusion will be increased by the increase in the consumer price index beginning in 1999.

Estate Taxes

Since the surviving joint owner(s) of an account become(s) the full owner(s) of the account upon death of the other owner(s), the decedent's contribution to the account is included in the decedent's taxable estate. See the following example.

Example 9D: Margaret put $20,000 into the account and Matt put in nothing. If Margaret dies in 2002 when the balance is $24,000, Matt becomes the full owner of the account. All of the $24,000 is in Margaret's taxable estate.

> **Practitioner Note.** If the co-owners of an account created after 1976 are married, then one-half of the account is included in the estate of the first to die, regardless of the contribution of the decedent.

IRS Levy on the Account

If either joint owner can withdraw from the account without the other's consent, then the IRS can levy on the account for taxes due from either owner. See the following example.

Example 9E: If Margaret put $20,000 into the account and Matt put in nothing, the IRS could levy on the account for taxes due from either Margaret or Matt.

If the account is a payable on death (POD) account, then the noncontributing owner cannot make a withdrawal while the contributing owner is still alive. Consequently, the IRS cannot levy on the account for taxes due from the noncontributing owner.

Example 9F: IF Margaret put $20,000 into a POD account and named Matt as the co-owner, the IRS could not levy the account for taxes due from Matt as long as Margaret is alive.

PROBLEM 10: TAXPAYER PENALTIES

BACKGROUND

The number of individual taxpayer penalties that the Internal Revenue Service can assess is staggering. In 1955 there were no more than 15 penalties in the Internal Revenue code. Now there are nearly **ten times** that number. As the enforcement of federal tax laws via revenue agent and tax auditor exams of tax returns decreases, Congress has decided to encourage and maintain voluntary compliance by the imposition of numerous penalties. This discussion of individual taxpayer penalties will focus on the most common and the procedures to appeal them.

1. Failure to File (FTF) Penalty [I.R.C. §6651(a)(1)]

This penalty is imposed for failure to file a tax return, by the date prescribed (including any approved extensions), unless it is shown that the failure to file is due to a **reasonable cause and not due to willful neglect.**

Note: The FTF penalty is calculated on the *later* **of the normal due date or the extension date** of the return.

The FTF penalty is 5% of the amount of tax **required to be shown on the return (as opposed to the tax reported on the return)** for each month, or fraction thereof that the failure continues, **not to exceed 25%.** The amount of tax **required to be shown on the return** is **reduced** by payments made **on or before the prescribed due date** of the return and by **any allowable credits** which may be claimed on the return. Timely payments include:

- **a.** Withholding credits
- **b.** Estimated tax payments
- **c.** Tax deposits (for example, those made with extension requests)
- **d.** Overpayments from prior periods
- **e.** Other payments made on or before the prescribed date

When the **failure to file (FTF) and** the **failure to pay (FTP)** penalty under I.R.C. §6651(a)(2) apply at the same time, the **failure to file** penalty is **reduced** by the **failure to pay** penalty. Therefore, in most of these situations, the result is that the **failure to file** penalty will be 4.5% and the **failure to pay** penalty will be 0.5%.

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Minimum Failure to File Penalty. A **minimum** failure to file penalty is imposed on all **individual** income tax returns delinquent for **more than 60 days.** This **minimum** penalty shall not be **less than smaller of:**

- **a.** $100, or
- **b.** 100% of the amount of tax required to be shown on the return.

Note: In one Tax Court case, the IRS **tried unsuccessfully** to assess the $100 minimum FTF penalty **even though there was no underpayment of tax because the taxpayer's withholding credits exceeded her total tax liability** [*Christine Patronik-Holder v. Commissioner*, 100 T.C. 374 (1993) [CCH Dec. 49,003].] The IRS lost this court case. As a result, the IRS acquiesced and has agreed to follow the decision reached by the Tax Court.

Reasonable cause exception. The failure to file penalty is **not automatic.** If a **reasonable cause** exists for the late filing, the penalty can be avoided (if considered by an IRS examiner but not yet assessed) or abated (already assessed). This **reasonable cause** exception is often overlooked by practitioners. There are three main reference sources to aid a practitioner in arriving at a **reasonable cause** to prevent or abate a FTF penalty. Those three sources are:

1. Numerous (over 500) court cases and several Revenue Rulings
2. IRS Regulations (see **Treas. Reg.** §301.6651-1(c))
3. Internal Revenue Manual–Penalty Handbook [see sections (20)130, **Relief from Penalties;** (20)132, **Reasonable Cause;** and (20)132.3, **Ordinary Business Care and Prudence**]

Space does not permit a listing of all of the possible **reasonable cause** exception possibilities, but the following are examples taken from the three sources.

Note: This list also applies to most other penalties where **reasonable cause relief is available.**

a. **Compliance history.** If this is the taxpayer's **first** incident of noncompliant behavior, weigh this factor with other reasons the taxpayer gives for **reasonable cause,** since a first-time failure to comply does **not** by itself establish **reasonable cause.** [Internal Revenue Manual (IRM)]
b. **Circumstances beyond the taxpayer's control.** (IRM)
c. **Ignorance of the law.** In some instances, taxpayers may **not** be aware of specific obligations to file and/or pay taxes. The **ordinary business care and prudence standard** requires that taxpayers make **reasonable efforts** to determine their tax obligations. (IRM)
d. **Mistake was made.** (IRM)
e. **Advice of a tax professional.** (IRM, numerous court cases)
f. **Death, serious illness, or unavoidable absence of taxpayer or taxpayer's immediate family.** (IRM) However, in four court cases, the illness or death of the taxpayer's accountant did **not** constitute reasonable cause.
g. **Inability to obtain records.** (IRM)
h. **Erroneous oral advice from an IRS employee.** (IRM)
i. **Fire, casualty, natural disaster, or other disturbance.** (IRM)

2. Fraudulent Failure to File (FFTF) Penalty [I.R.C. §6651(f)]

For returns due after December 31, 1989 (determined **without** regard to extensions), the **traditional** fraud penalty under I.R.C. §6663 applies **only where a return has been filed.** In order to severely penalize taxpayers who fail to file a return **with the intent to evade tax,** I.R.C. §6651(f) was enacted.

The FFTF penalty is equal to **15%** of the amount **required to be shown on the return** (the **corrected** tax), **less timely credits,** for **each** month the return is delinquent, **up to 75%.** The FFTF penalty is computed in the same manner as the failure to pay penalty, with **15% substituted for 5%.**

According to the Internal Revenue Manual, used by IRS examiners, the following factors should be considered in developing a FFTF penalty issue:

a. The taxpayer refuses or is unable to explain his failure to file.

b. The taxpayer's testimony does not meet or agree with the facts of the case.

c. There is a **history of failing to file or late filing, but an apparent ability to pay.**

d. The taxpayer fails to reveal or tries to hide assets.

e. The taxpayer pays personal and business expenses in cash when cash payments are not usual, or cashes rather than deposits checks that are business receipts.

f. In addition to the above, the taxpayer's **occupation** shows that he or she **should be aware of the obligation to pay tax (e.g., lawyers, teachers, accountants, real estate brokers, and public officials, regardless of the amount of tax due).**

On a late filed return, **the 75% traditional fraud and FFTF penalties may be asserted for the same tax year. Thus, it is possible for a taxpayer to be subject to the two penalties, equal to 150% of the tax deficiency!**

Example. An attorney failed to file income tax returns for the years 1992 through 1997. He had sufficient funds to pay his federal income tax obligation. An IRS exam of his **delinquent** 1995 tax return results in a **corrected total tax of $25,000.** The only **timely credits were $10,000 of income tax withholding** from his wages. The total of the **FFTF penalty and the traditional fraud penalty** assessed by the IRS **could be $22,5000, or 150% of the $15,000 tax deficiency** for 1995.

Note: The burden of proof is on the IRS to establish that the failure to file was fraudulent. The IRS must show with clear and convincing evidence that the failure to file **was done fraudulently with the intent to evade taxes.**

3. Failure to Pay (FTP) Penalty [I.R.C. §6651(a)(2)]

This penalty is imposed if the tax shown on **any** return, other than an information return, is **not paid by the due date of that return.** The FTP penalty applies to **original and amended** returns filed by the taxpayer. The FTP penalty does **not** apply when the failure to pay is **due to reasonable cause and not willful neglect.**

When IRS examiners secure delinquent returns from taxpayers or use the substitute for return procedure, they must advise the IRS service center as to whether the FTP penalty should be asserted. If **reasonable cause exists,** the examiner will advise the nonassertion of the penalty.

> **Practitioner Caution.** If you and your delinquent tax client are dealing with the IRS, you should explore the possibility of **reasonable cause** to prevent the assertion of the FTP penalty. It may be easier to convince the IRS examiner or revenue officer that **reasonable cause** exists than to argue about abatement of the penalty later with the service center or an appeals officer.

The FTP penalty is one-half of 1% (0.005) of unpaid tax for the first month the penalty applies, and an additional one-half of 1% for each additional month or fraction of the month the tax remains unpaid. The **maximum** FTP penalty is 25%. The penalty is computed **on the tax shown on the return less timely payments and credits.** It is **not** computed on the tax required to be shown on the return (the corrected tax).

Reasonable Cause Exception. See the discussion for the failure to file penalty above. Lack of funds is the primary reason for failure to pay. However, lack of funds is an **acceptable reasonable cause only when the taxpayer can demonstrate that the lack of funds occurred despite the exercise of**

ordinary business care and prudence. See section (20)132.3 of the Internal Revenue Manual–Penalty Handbook for guidance on what constitutes **ordinary business care and prudence.**

4. Failure to Pay Estimated Tax Penalty (I.R.C. §6654)

This penalty is imposed on the underpayment of estimated tax by individuals. The penalty applies to U.S. citizens and residents, nonresident aliens, and residents of Puerto Rico, the Virgin Islands, Guam, and American Samoa.

There are two exceptions provided by I.R.C. §6654(e) to the penalty. An individual is **not** required to make quarterly estimated tax payments if either (a) or (b) below is applicable:

a. **For tax years beginning after 1997,** the **total tax** shown on Form 1040 **less the amount paid through withholding is less than $1,000.** (**Note:** For tax years beginning **before 1998,** the threshold was $500.)

b. The individual did **not** have any tax liability for the **preceding tax year and such preceding year was a full (12 months) tax year.**

General Rule for 1998 Estimated Tax Payments. Estimated tax payments must be made if an individual taxpayer expects to owe **at least $1,000 in tax for 1998, after subtracting withholding, and the withholding amount is less than the smaller of:**

a. 90% of the tax shown on the **1998** tax return, or

b. 100% of the tax shown on the **1997** tax return. The 1997 return must cover 12 months.

Note: There is an exception for farmers and fishermen.

Estimated Tax Safe Harbor for High-income Individuals. For 1998 estimated tax installments, the estimated tax **safe harbor** for high-income individuals (other than farmers and fishermen) **has been modified.** If the taxpayer's 1998 adjusted gross income is **more than $150,000 ($75,000 if married and filing a separate return),** the penalty does not apply if 1998 estimated tax payments are **at least the lesser of:**

a. **90%** of the taxpayer's **1998** tax liability, or

b. **100%** of the **1997** total tax shown on the 1997 return covering all 12 months.

Note: If a taxpayer's **1998** adjusted gross income is **more than $150,000 ($75,000 if married and filing a separate return), 1999** estimated tax payments **may be based on 105% of the 1998 tax liability** in order to avoid the penalty.

Important Change for 1998 Estimated Taxes. Beginning in 1998, **household employment (social security, Medicare, and federal unemployment) taxes** (for household employees of the taxpayer) must be included when figuring 1998 estimated taxes if **either** of the following applies:

a. Federal income tax is withheld from the taxpayer's wages, pensions, annuities, gambling winnings, or other income, **or**

b. 1998 estimated tax payments would be required to avoid the penalty **even if no household employment tax were owed.**

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Practitioner Caution. If any of your clients employ household employees, either 1998 withholding or estimated tax payments should be increased in order to prepay household employment taxes. If this is not done, your clients may be subject to a 1998 estimated tax penalty.

Note: Household employment taxes are entered on **line 12 (Other taxes)** on the **1998 Estimated Tax Worksheet** found in the **1998 Form 1040-ES** package. See the 1998 Schedule H (Household Employment Taxes) on page 618.

Reasonable cause exception for the estimated tax penalty. Reasonable cause as normally considered does **not** apply to the estimated tax penalty. However, the IRS may **waive** the penalty under the **two** following circumstances:

- **a.** It is determined that, by reason of casualty, disaster, or other unusual circumstances, the imposition of the penalty would be **against equity and good conscience** [I.R.C. §6654(e)(3)(A)].
- **b.** The taxpayer **retired after having reached age 62, or became disabled** in **either** the current or preceding tax year **and** the underpayment was due to **reasonable cause and not to willful neglect** [I.R.C. §6654(e)(3)(B)].

Note: To apply for one of these two waivers, an explanation should be attached to Form 2210 complete with any documentation.

Practitioner Suggestion. The estimated tax penalty is a huge revenue generator for IRS. The **Note** at the top of Form 2210 states: "In most cases, you **do not** need to file Form 2210. The IRS will figure any penalty you owe and send you a bill."

However, many taxpayers will owe **far less** of an estimated tax penalty than the one the IRS service center computes and bills **if the annualized income installment method is used on Form 2210.** Even though the **annualized income installment method** can be time-consuming, it may well be worth your time and your client's time to use it to minimize or eliminate the penalty.

The explanation and example contained in **IRS Publication 505** (*Tax Withholding and Estimated Tax*) on how to use the **annualized income installment method** is an excellent reference source.

5. 20% Accuracy-Related Negligence Penalty [I.R.C. §6662(b)(1)]

This penalty is applied as a result of IRS examinations. It imposes a 20% penalty on the **portion of underpayment attributable to negligence.** The 20% rate of penalty applies to returns due after December 31, 1989. The computation of the penalty can be cumbersome for IRS examiners. The reason is that, in many exam situations, only a **portion of the adjustments** proposed by the IRS examiner will be deemed to be caused by the negligent acts of the taxpayer.

Example. Eli Farmer's 1996 Form 1040 was examined by the IRS. The IRS revenue agent determined that the following adjustments should be made to Eli's 1996 Schedule F:

Item	Adjustment	Reason for Error
1. Grain sales	$46,700 increase in income	Three grain sales out of a total of 12 were omitted. All 12 were deposited to the farm checking account.
2. §179 deduction	$15,000 increase in income	Eli bought a used tractor from his grandfather for $15,000 and incorrectly expensed it under I.R.C. §179 on Form 4562.
3. Storage expense	$3,200 increase in income	Eli double-deducted elevator storage, as he reported only the net grain checks (after the storage deduction) on line 4 of Schedule F.

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Item	Adjustment	Reason for Error
4. Fertilizer	$3,600 increase in income	Eli made a math error in the farm record book for the eight separate fertilizer entries. The eight entries in the book were correct, but the total was overstated by $3,600.
5. Omitted MACRS on tractor acquired from grandfather	$1,071 decrease in income	See number 2 above

Revenue agent's conclusion. In the opinion of the revenue agent, Adjustments #1 ($46,700 omitted grain sales) and #3 ($3,200 overstated storage expense) were due to Eli's **negligence.** Adjustment #4 ($3,600 overstated fertilizer expense) was borderline, but the revenue agent decided it did **not** meet the definition for negligence.

Therefore, the revenue agent's exam report will show the assertion of the 20% accuracy-related penalty for **negligence.** The 20% penalty will be applied to the **additional income and self-employment tax that was created by adjustments #1 and #4 only.** The computerized exam report should clearly show this computation. The computation of the 20% negligence penalty should show that only adjustments #1 and #4 were considered in computing the penalty.

Definition of Negligence. The following definition of negligence is from **Treas. Reg.** §1.6662-3.

> The term "negligence" includes any failure to make a **reasonable attempt** to comply with the provisions of the internal revenue laws or to exercise **ordinary and reasonable care in the preparation of a tax return. "Negligence" also includes any failure of the taxpayer to keep adequate books and records or to substantiate items properly.** Negligence is strongly indicated where–
>
> **(i)** A taxpayer **fails to include on an income tax return an amount of income shown on an information return;**
>
> **(ii)** A taxpayer fails to make a **reasonable attempt to ascertain the correctness of a deduction, credit or exclusion** on a return which would seem to a reasonable and prudent person **to be "too good to be true"** under the circumstances.

Notes.

1. In numerous court cases involving the imposition of the negligence penalty, the following definition of the term "negligence" has evolved: **"The lack of due care or failure to do what a reasonable and prudent person would do under the circumstances."**
2. The 20% penalty also applies to **"disregard of rules or regulations"** (as well as negligence) according to the language of I.R.C. §6662(b)(1).

Reasonable cause exception to the 20% accuracy-related negligence penalty. For tax returns that are due after 1993, the negligence penalty can be avoided **"upon a showing by the taxpayer that there was reasonable cause for the underpayment, and the taxpayer acted in good faith."** [I.R.C. §6664(c)(1) and **Treas. Reg.** §1.6664-4(a)]. See the discussion for the **failure to file penalty** above for reasonable cause criteria.

Practitioner Caution. The 20% accuracy-related **negligence** penalty **cannot be avoided by using the adequate disclosure exception** (**Treas. Reg.** §1.6662.1). This restriction applies to returns due **after** December 31, 1993.

However, the **adequate disclosure exception can** be used to avoid the 20% penalty imposed because the taxpayer has taken a position on a return contrary to a rule or regulation (**see Note 2 above**). For returns due **after December 31, 1993,** adequate disclosure can be made **only** by properly completing **Forms 8275 or 8275-R** (for a return position that is contrary to an IRS Treasury Regulation). See pages 107–111 in the *1995 Farm Income Tax Book* for more information about disclosure, including a completed Form 8275.

6. 20% Accuracy-Related Substantial Understatement of Tax Penalty [I.R.C. §6662(b)(2)]

This penalty is imposed if the understatement of income tax for the taxable year **exceeds the greater of:**

- **a.** 10% of the tax required to be shown on the return (the corrected tax), or
- **b.** $5,000 ($10,000 for corporations other than S corporations or personal holding companies).

The penalty is applied as a result of IRS examinations. It is asserted by the IRS only on filed returns.

Example. Brenda Hill's 1996 Form 1040 was examined by the IRS. She reported a total tax liability of $8,300. The IRS examiner found numerous adjustments. The 1996 exam report disclosed a corrected total tax liability of $14,500. **Brenda's understatement of income tax for 1996 is $6,200.**

Computation of the greater of 10% of the corrected tax or $5,000:

- **a.** 10% of the corrected tax: 10% of $14,500 = **$1,450,** or
- **b.** **$5,000**

The greater of (a) or (b) is $5,000. Since Brenda's 1996 **understatement of her 1996 income tax of $6,200 exceeds $5,000,** the IRS examiner may decide to impose the 20% accuracy-related penalty. If that is done, **the proposed penalty on the 1996 exam report will be $1,240** (20% × $6,200).

Exceptions to the 20% Accuracy-Related Penalty for Substantial Understatement of Tax.
There are **three** exceptions to the penalty. Either of the three exceptions can be used to reduce the understatement of income tax on which the penalty is calculated. The three exceptions are:

1. Substantial authority [I.R.C. §6662(d)(2)(B)(i)]
2. Adequate disclosure [I.R.C. §6662(d)(2)(B)(ii)]
3. Reasonable cause and good faith [I.R.C. §6664(c)(1) and **Treas. Reg.** §1.6664-4(a)]

Substantial authority exception. The amount of the total understatement of income tax will be reduced by **that portion of the understatement which is due to substantial authority.** See pages 381-382 for a thorough discussion of what constitutes substantial authority.

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Adequate disclosure exception. The amount of the total understatement of income tax will be reduced by **that portion of the understatement that is due to adequate disclosure.** The taxpayer must have a **reasonable basis** for the position taken on the return for the disclosed item. [I.R.C. §6662(d)(2)(B)(ii)(II)]. **This reasonable basis standard is a fairly high standard and will not be satisfied by a return position that is merely arguable.** See the discussion for the **20% accuracy-related negligence penalty** above for disclosure information.

Reasonable cause and good faith exception. I.R.C. §6664(c)(1) and **Treas. Reg.** §1.6664-4(a) sanction this exception to the substantial understatement of tax penalty. See the discussion for the **failure to file penalty** above.

7. Procedures for Requesting Penalty Relief

With all of the negative publicity inflicted on the IRS by the Senate Finance Committee hearings, IRS enforcement and service center employees may be more sympathetic to a penalty relief request. The following excerpts are from the **Internal Revenue Manual–Penalty Handbook** (IRM-PH) dated July 15, 1996 (the latest revision).

Requesting Penalty Relief [§(20)135]. The initial request for relief may occur either after an examination, but **before** a penalty is actually assessed, or **with a return that is either filed or paid late.** When the request is received, carefully analyze the taxpayer's reasons to determine if penalty relief is warranted. **The burden of proof is generally on the taxpayer.**

Methods of Appealing Penalties [§(20)140]. Various administrative and legislative remedies are provided for taxpayers who disagree with the Service's determination that they are liable for a particular penalty. Generally, when a taxpayer **disagrees** with our determination regarding a penalty, they have the right to an administrative appeal.

Taxpayers **have the right to challenge** the assertion or assessment of a penalty, and generally may do so **at any stage** in the **penalty process.** Taxpayers may request:

A. A review of the penalty **prior to assessment.** (The IRM-PH refers to this process as **"preassessment appeal."**)

Editorial notes.

1. In most situations, this would be with the IRS examining officer. If the examiner is unsympathetic to your request, you should ask for a **"closing conference"** with the examiner **and his/her group manager.** The group manager has the authority to overturn the examiner's decision to assert the disputed penalty. If this request **not to assert the disputed penalty** is denied by the examining officer's group manager, a **"preassessment appeal"** can be made to the **Appeals Office** of the IRS. See editorial note 2, which follows.
2. According to section (20)142.21 of the IRM-PH (dated 7-15-96), **"the Appeals Office generally will consider the following type of penalties** *prior* **to assessment: penalties which are asserted by the Service in the course of an examination of a taxpayer's income tax return. Generally, if Appeals considers a penalty** *before* **it is assessed, Appeals will not reconsider the penalty after it is assessed.**

   However, at its discretion, Appeals may reconsider its prior decision if evidence becomes available that indicates further consideration is warranted.

   Taxpayers may also pay the penalty previously upheld by Appeals, and file a claim for refund. The claim for refund may be brought to Appeals if denied."
3. Practitioners may want to refer to the following for more detailed Appeals procedures:
   - **a.** Internal Revenue Manual (IRM) 8(11)00
   - **b.** Text 600 of IRM 8114, **Appeals Returns Processing and Control Handbook**

B. A penalty **abatement after it is assessed and either before or after it is paid.** (The IRM-PH refers to this process as a **"postassessment review."**) To request abatement of a penalty after assessment, the taxpayer must submit a written request to the Service.

C. An abatement and refund after payment. Note: This is apparently done via a claim for refund using Form 843.

8. Important Penalty Provisions of the IRS Restructuring and Reform Act of 1998

A. The IRS must now include on each required notice of penalty, the Code section that authorizes the penalty and the computation that results in the penalty shown on the notice [new I.R.C. §6751(c)].

B. Penalties may not be assessed unless the initial determination of the assessment is **personally approved, in writing, by the immediate supervisor** of the individual making the determination (or a higher-level official if the IRS so designates) [new I.R.C. §6751(b)(1)].

C. Effective date of these new provisions: They apply to notices issued and penalties assessed **after December 31, 2000.**

9. Penalty Policy Statement of the Internal Revenue Service

Penalties constitute one important tool of the Internal Revenue Service in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the Service's mission *only* if penalties enhance voluntary compliance. Even though other results, such as raising of revenue, punishment, or reimbursement of the costs of enforcement, may also arise when penalties are asserted, the Service will design, administer, and evaluate penalty programs solely on the basis of whether they do the best possible job of encouraging compliance conduct.

In the interest of an effective tax system, the Service uses penalties to encourage voluntary compliance by: (1) helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.

To this end, the IRS administers a penalty system that is designed to:

- ensure consistency;
- ensure accuracy of results in light of the facts and the law;
- provide methods for the taxpayer to have his or her interests heard and considered;
- require impartiality and a commitment to achieve the correct decision;
- allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate;
- ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases.

The Service maintains an ongoing effort to develop, monitor, and revise programs designed to assist taxpayers in complying with legal requirements and, thus, avoid penalties.

To ensure consistency, the Service prescribes and uses a single set of guidelines in a **Penalty Handbook** which will be followed by **all** operational and processing functions. Prior to implementation, changes to the Penalty Handbook must be reviewed for consistency with Service Policy and approved by the Office of Penalty Administration.

The Service collects statistical and demographic information to evaluate penalties and penalty administration and how they relate to the goal of voluntary compliance. The Service continually evaluates the impact of the penalty program on compliance and recommends changes when the statutes or administration of penalties are not effectively promoting voluntary compliance.

10. Penalty Relief—Application Chart (Internal Revenue Manual—Penalty Handbook)

IRC Section	Type of Penalty	Reasonable Cause Relief	Other Relief
6651(a)(1)	Failure to File	Yes	Yes
6651(a)(2)	Failure to Pay when due	Yes	Yes
6651(a)(3)	Failure to Pay within 10 Days of Notice of Additional Tax Due	Yes	Yes
6651(d)	Failure to Pay within 10 Days of Final Notice and Demand	Yes	Yes
6651(f)	Fraudulent Failure to File	Yes	Yes
6652(a)(1)**	Failure to File Information Returns	Yes	Yes
6652(c)(1)	Failure to File Annual Return by Exempt Organization	Yes	Yes
6652(c)(2)	Failure to File Returns under IRC Section 6034 or 6043(b)	Yes	Yes
6652(d)(2)	Notification of Change in Status of a Plan	Yes	Yes
6652(e)	Information Required in Connection with Certain Plans of Deferred Compensation-Form 5500		
Form 5500	Yes	Yes	
6652(h)	Failure to Give Notice to Recipients of Certain Pension, etc., Distributions	Yes	Yes
6652(i)	Failure to Give Written Explanation to Recipients of Certain Qualifying Rollover Distributions	Yes	Yes
6653(a)*	Negligence	No	Yes*
6653(b)*	Fraud	No	Yes*
6654	Estimated Tax Penalty on Individuals	No	Statutory Exception
6655	Estimated Tax Penalty on Corporations	No	No
6656(a)	Failure to Deposit	Yes	Yes
6657	Bad Check	Yes	Yes
6659*	Valuation Overstatement	No	Yes
6659A*	Overstatement of Pension Liabilities	No	Yes
6661*	Substantial Understatement	No	Yes
6662	Accuracy-Related	Yes	Yes
6663	Fraud	Yes	Yes
6692	Failure to File Actuarial Report	Yes	Yes
6698	Failure to File Partnership Return	Yes	Yes
6721	Failure to File Correct Information Reporting Returns	Yes	Yes
6722	Failure to Furnish Correct Payee Statements	Yes	Yes
6723	Failure to Comply with other Information Reporting Requirements	Yes	Yes

* Repealed for tax returns filed after December 31, 1989.
** Repealed for tax returns filed after December 31, 1986.

PROBLEM 11: SIMPLE IRA PLANS

For tax years beginning after 1996, employers (including self-employed taxpayers) that have no more than 100 employees who received at least $5,000 of compensation from the employer during the preceding year may sponsor a SIMPLE IRA plan on behalf of eligible employees.

Contributions are made on behalf of eligible employees. Contributions are subject to various limits. All contributions under a SIMPLE IRA plan must be made to SIMPLE IRAs, not to any other type of IRA.

In addition to salary reduction contributions, an employer must make either matching contributions or nonelective contributions.

Comment. The IRS has taken the position that a calendar year employer must establish a SIMPLE IRA plan no later than October 1 of the year in which it is to become effective.

Practitioner Note. The **selections** [not all Q&As are included herein] from **Notice** 98-4 which follow provide the details regarding SIMPLE IRAs in a question and answer format. (I.R.B. 1998-2, December 23, 1997)

Table of Contents

Questions and Answers

A. SIMPLE IRA Plans in General

Q. A-1: *What is a SIMPLE IRA Plan?*

Key Point + A. A-1: A SIMPLE IRA Plan is a written arrangement established under §408(p) of the Code that provides a simplified tax-favored retirement plan for small employers. If an employer establishes a SIMPLE IRA Plan, each employee may choose whether to have the employer make payments as contributions under the SIMPLE IRA Plan or to receive these payments directly in cash. An employer that chooses to establish a SIMPLE IRA Plan must make either matching contributions or nonelective contributions. All contributions under a SIMPLE IRA Plan are made to SIMPLE IRAs.

Key Point + Q. A-2: *Can contributions made under a SIMPLE IRA Plan be made to any type of IRA?*

A. A-2: Contributions under a SIMPLE IRA Plan may only be made to a SIMPLE IRA, not to any other type of IRA. A SIMPLE IRA is an individual retirement account described in §408(a), or an individual retirement annuity described in §408(b), to which the only contributions that can be made are contributions under a SIMPLE IRA Plan and rollovers or transfers from another SIMPLE IRA.

Q. A-3: *Can a SIMPLE IRA Plan be maintained on a fiscal year basis?*

A. A-3: A SIMPLE IRA Plan may only be maintained on a calendar year basis. Thus, for example, employer eligibility to establish a SIMPLE IRA Plan (see Q&As B-1 through B-5) and SIMPLE IRA Plan contributions (see Q&As D-1 through D-6) are determined on a calendar-year basis.

B. Employers That Can Establish SIMPLE IRA Plans

Q. B-1: *Can any employer establish a SIMPLE IRA Plan?*

Key Point + A. B-1: SIMPLE IRA Plans may be established only by employers that had no more than 100 employees who earned $5,000 or more in compensation during the preceding calendar year (the "100-employee limitation"). See Q&As C-4 and C-5 for the definition of compensation. For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE IRA Plan. Thus, employees who are excludable under the rules of §410(b)(3) or who have not met the plan's minimum eligibility requirements must be taken into account. Employees also include self-employed individuals, described in §401(c)(1) who received earned income from the employer during the year.

Q. B-2: *Is there a grace period that can be used by an employer that ceases to satisfy the 100-employee limitation?*

A. B-2: An employer that previously maintained a SIMPLE IRA Plan is treated as satisfying the 100-employee limitation for the 2 calendar years immediately following the calendar year for which it last satisfied the 100-year employee limitation. However, if the failure to satisfy the 100-employee limitation is due to an acquisition, disposition or similar transaction involving the employer, then the 2-year grace period will apply only in accordance with rules similar to the rules of §410(b)(6)(C)(i).

Q. B-3: *Can an employer make contributions under a SIMPLE IRA Plan for a calendar year if it maintains another qualified plan?*

Key Point + A. B-3: Generally, an employer cannot make contributions under a SIMPLE IRA Plan for a calendar year if the employer, or a predecessor employer, maintains a qualified plan (other than the SIMPLE IRA Plan) under which any of its employees receives an allocation of contributions (in the case of a defined contribution plan) or has an increase in a benefit accrued or treated as an accrued benefit under §411(d)(6) (in the case of a defined benefit plan) for any plan year beginning or ending in that calendar year.

Q. B-4: *Are tax-exempt employers and governmental entities permitted to maintain SIMPLE IRA Plans?*

A. B-4: Yes. Excludable contributions may be made to the SIMPLE IRA of employees of tax-exempt employers and governmental entities on the same basis as contributions may be made to employees of other eligible employers.

Q. B-5: *Do the employer aggregation and leased employee rules apply for purposes of the SIMPLE IRA Plan Rules Under §408(p)?*

Key Point + A. B-5: For purposes of applying the SIMPLE IRA Plan rules under §408(p), certain related employers (trades or businesses under common control) are treated as a single employer. These related employers include controlled groups of corporations under §414(b), partnerships or sole proprietorships under common control under §414(c), and affiliated service groups under §414(m). In addition, leased employees described in §414(n) are treated as employed by the employer.

Example: Individual P owns Business A, a computer rental agency, that has 80 employees who received more than $5,000 in compensation in 1996. Individual P also owns Business B, which repairs computers and has 60 employees who received more than $5,000 in compensation in 1996. Individual P is the sole proprietor of both business. Section 414(c) provides that the employees of partnerships and sole proprietorships that are under common control are treated as employees of a single employer. Thus, for purposes of the SIMPLE IRA Plan rules, all 140 employees are treated as employed by Individual P. Therefore, neither Business A nor Business B is eligible to establish a SIMPLE IRA Plan for 1997.

C. Employee Eligibility to Participate in a SIMPLE IRA Plan

Q. C-1: *Which employees of an employer must be eligible to participate under the SIMPLE IRA Plan?*

Key Point + A. C-1: If an employer establishes a SIMPLE IRA Plan, all employees of the employer who received at least $5,000 in compensation from the employer during any 2 preceding calendar years (whether or not consecutive) and who are reasonably expected to receive at least $5,000 in compensation during the calendar year, must be eligible to participate in the SIMPLE IRA Plan for the calendar year.

An employer, at its option, may exclude from eligibility employees described in §410(b)(3). These employees are:

1. Employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and

one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers;

2. In the case of a trust established or maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with Title II of the Railway Labor Act and one or more employees, all employees not covered by that agreement; and
3. Employees who are nonresident aliens and who received no earned income (within the meaning of §911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of §861(a)(3)).

Moreover, during the calendar year in which an acquisition, disposition or similar transaction occurs (or the following calendar year), an employer may exclude from eligibility all of the employees who would not have been eligible if the transaction had not occurred (and thus the employer maintaining the SIMPLE IRA Plan had remained a separate employer). See paragraph (2) of Q&A B-3 for circumstances in which exclusion of these employees would be required.

As noted in Q&A B-5, the employer aggregation and leased employee rules apply for purposes of §408(p). Thus, for example, if two related employers must be aggregated under the rules of §414(b), all employees of either employer who satisfy the eligibility criteria must be allowed to participate in the SIMPLE IRA Plan.

Q. C-2: *May an employer impose less restrictive eligibility requirements?*

A. C-2: An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both, under its SIMPLE IRA Plan. For example, the employer could allow participation for employees who received $3,000 in compensation during any preceding calendar year. However, the employer cannot impose any other conditions on participating in a SIMPLE IRA Plan.

Q. C-3: *May an employee participate in a SIMPLE IRA Plan if he or she also participates in a plan of a different employer for the same year?*

Key Point + A. C-3: An employee may participate in a SIMPLE IRA Plan even if he or she also participates in a plan of a different employer for the same year. However, the employee's salary reduction contributions are subject to the limitations of §402(g), which provides an aggregate limit on the exclusion for elective deferrals for any individual. Similarly, an employee who participates in a SIMPLE IRA Plan and an eligible deferred compensation plan described in §457(b) is subject to the limitations described in §457(c). An employer that establishes a SIMPLE IRA Plan is not responsible for monitoring compliance with either of these limitations.

Q. C-4: *What definition of compensation applies for purposes of the SIMPLE IRA Plan rules in the case of an individual who is not a self-employed individual?*

A. C-4: For purposes of the SIMPLE IRA Plan rules, in the case of an individual who is not a self-employed individual, compensation means the amount described in §6051(a)(3) (wages, tips, and other compensation from the employer subject to income tax withholding under §3401(a)), and amounts described in §6051(a)(8), including elective contributions made under a SIMPLE IRA Plan, and compensation deferred under a §457 plan. For purposes of applying the 100-employee limitation, and in determining whether an employee is eligible to participate in a SIMPLE IRA Plan (i.e., whether the employee had $5,000 in compensation for any 2 preceding years), an employee's compensation also includes the employee's elective deferrals under a §401(k) plan, a salary reduction SEP and a §403(b) annuity contract.

Q. C-5: *What definition of compensation applies for purposes of the SIMPLE IRA Plan rules in the case of a self-employed individual?*

Key Point + A. C-5: For purposes of the SIMPLE IRA Plan rules, in the case of a self-employed individual, compensation means net earnings from self-employment determined under §1402(a), prior to subtracting any contributions made under the SIMPLE IRA Plan on behalf of the individual.

D. SIMPLE IRA Plan Contributions

Q. D-1: *What contributions must an employer make under a SIMPLE IRA Plan?*

Key Point + A. D-1: If an employer establishes a SIMPLE IRA Plan, it must make salary reduction contributions, as described in Q&A D-2, to the extent elected by employees. In addition, the employer must make employer matching contributions, as described in Q&As D-4 and D-5, or employer nonelective contributions, as described in Q&A D6. These are the only contributions that may be made under a SIMPLE IRA Plan.

Q. D-2: *What is a salary reduction contribution?*

A. D-2: A salary reduction contribution is a contribution made pursuant to an employee's election to have an amount contributed to his or her SIMPLE IRA, rather than have the amount paid directly to the employee in cash. An employee must be permitted to elect to have salary reduction contributions made at the level specified by the employee, expressed as a percentage of compensation for the year. Additionally, an employer may permit an employee to express the level of salary reduction contributions as a specific dollar amount. An employer may not place any restrictions on the amount of an employee's salary reduction contributions (e.g., by limiting the contribution percentage), except to the extent needed to comply with the annual limit on the amount of salary reduction contributions described in Q&A D-3.

Q. D-3: *What is the annual limit on the amount of salary reduction contributions under a SIMPLE IRA Plan?*

Key Point + A. D-3: For 1997 (and for 1998), the maximum annual amount of salary reduction contributions that can be made on behalf of any employee under a SIMPLE IRA Plan is $6,000. This amount will be adjusted by the Service to reflect any changes in the cost of living.

Q. D-4: *What employer matching contribution is generally required under a SIMPLE IRA Plan?*

Key Point + A. D-4: Under a SIMPLE IRA Plan, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee's salary reduction contributions, up to a limit of 3 percent of the employee's compensation for the entire calendar year.

Practitioner Note:

Example 1. In 1998, Paul was a participant in his employer's SIMPLE plan. His compensation, before SIMPLE plan contributions, was $41,600 or $800 per week. Instead of taking it all in cash, Paul elected to have 12.5% of his weekly pay ($100) contributed to his SIMPLE IRA. For the full year, Paul's salary reduction contributions were $5,200, which is less than the $6000 limit on these contributions.

Under the plan, Paul's employer was required to make matching contributions to Paul's SIMPLE IRA. Because the employer's matching contributions must equal Paul's salary reduction, but cannot be more than 3% of his compensation (before salary reductions) for the year, his employer's contribution was limited to $1,248 (3% of $41,600.)

Example 2. Assume the same facts as in Example 1, except that Paul's compensation for the year was $240,000 and he chose to have 2.5% of his weekly pay contributed to his SIMPLE IRA. In this example, Paul's salary reduction contributions for the year (2.5% times $240,000) were equal to the 1998 limit for salary reduction contributions $6,000. Because 3% of Paul's compensation (7,200) is more than the amount the employer was required to match (6,000), the employer's matching contributions were limited to $6,000. In this example, total contributions made on Paul's behalf for the year were $12,000, the maximum contributions permitted under a SIMPLE plan for 1998.

Key Point + Q. D-5: *Can the 3-percent limit on matching contributions be reduced?*

A. D-5: The 3-percent limit on matching contributions is permitted to be reduced for a calendar year at the election of the employer, but only if:

1. The limit is not reduced below 1 percent;
2. The limit is not reduced for more than 2 years out of the 5-year period that ends with (and includes) the year for which the election is effective; and
3. Employees are notified of the reduced limit within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements. See Q&A E-1.

For purposes of applying the rule described in paragraph (2) of this Q&A D-5, in determining whether the limit was reduced below 3 percent for a year, any year before the first year in which an employer (or a predecessor employer) maintains a SIMPLE IRA Plan will be treated as a year for which the limit was 3 percent. If an employer chooses to make nonelective contributions for a year (see Q&A D-6), that year also will be treated as a year for which the limit was 3 percent.

Q. D-6: *May an employer make nonelective contributions instead of matching contributions?*

A. D-6: As an alternative to making matching contributions under a SIMPLE IRA Plan (as described in Q&A D-4 and D-5), an employer may make nonelective contributions equal to 2 percent of each eligible employee's compensation for the entire calendar year. The employer's nonelective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit nonelective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year.

For purposes of the 2-percent nonelective contribution, the compensation taken into account must be limited to the amount of compensation that may be taken into account under §401(a)(17) for the year. The §401(a)(17) limit for 1997 (and for 1998) is $160,000. This amount will be adjusted by the Service for subsequent years to reflect changes in the cost of living.

An employer may substitute the 2-percent nonelective contribution for the matching contribution for a year, only if:

1. Eligible employees are notified that a 2-percent nonelective contribution will be made instead of a matching contribution; and
2. This notice is provided within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements. See Q&A E-1.

Practitioner Note:

Example 3. Assume the same facts as in Example 2, except that Paul's employer chose to make nonelective contributions instead of matching contributions. Because, the employer's nonelective contributions are limited to 2% of up to $160,000 of Paul's compensation, the employer's contribution to Paul's SIMPLE IRA was limited to $3,200 for 1998. In this example, total contributions made on Paul's behalf for the year were $9,200 (Paul's salary reductions of $6,000 plus the employer's contribution of $3,200).

E. Employee Elections.

Q. E-1: *When must an employee be given the right to enter into a salary reduction agreement?*

Key Point + A. E-1: During the 60-day period immediately preceding January 1 of a calendar year (i.e., November 2 to December 31 of the preceding calendar year), an eligible employee must be given the right to enter into a salary reduction agreement for the calendar year, or to modify a prior agreement (including reducing the amount subject to this agreement to $0). However, for the year in which the employee becomes eligible to make salary reduction contributions, the period during which the employee may enter into a salary reduction agreement or modify a prior agreement is a 60-day period that includes either the date the employee becomes eligible or the day before that date. For example, if an employer establishes a SIMPLE IRA Plan effective as of July 1, 1997, each eligible employee becomes eligible to make salary reduction contributions on that date and the 60-day period must begin no later than July 1 and cannot end before June 30, 1997.

During these 60-day periods, employees have the right to modify their salary reduction agreements without restrictions. In addition, for the year in which an employee becomes eligible to make salary reduction contributions, the employee must be able to commence these contributions as soon as the employee becomes eligible, regardless of whether the 60-day period has ended.

Q. E-2. *Can a SIMPLE IRA Plan provide additional or longer election periods?*

A. E-2: Nothing precludes a SIMPLE IRA Plan from providing additional or longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements. For example, a SIMPLE IRA Plan can provide a 90-day election period instead of the 60-day period described in Q&A E-1. Similarly, in addition to the 60-day period described in Q&A E-1, a SIMPLE IRA Plan can provide quarterly election periods during the 30 days before each calendar quarter.

Q. E-3: *Does an employee have the right to terminate a salary reduction agreement outside a SIMPLE IRA Plan's normal election period?*

A. E-3: An employee must be given the right to terminate a salary reduction agreement for a calendar year at any time during the year. A SIMPLE IRA Plan may provide that an employee who terminates a salary reduction agreement at any time other than the periods described in Q&A E-1 or E-2 is not eligible to resume participation until the beginning of the next calendar year.

Q. E-4: *Must an employer allow an employee to select the financial institution to which the employer will make all SIMPLE IRA Plan contributions on behalf of the employee?*

Key Point + A. E-4: Generally, under §408(p), an employer must permit an employee to select the financial institution for the SIMPLE IRA to which the employer will make all contributions on behalf of the employee. The employee must communicate to the employer the name of the financial in situation selected and any additional information necessary to facilitate transmittal of the contribution to that institution. The Model Salary Reduction Agreement on page 3 of Form 5304-SIMPLE can be used for this purpose. Alternatively, under the exception described in Q&A J-1, an employer may require that all contributions on behalf of employees be made to a specified designated financial institution.

F. Vesting Requirements

Q. F-1: *Must contributions under a SIMPLE IRA Plan be nonforfeitable?*

A. F-1: Yes. All contributions under a SIMPLE IRA Plan must be fully vested and nonforfeitable when made.

Q. F-2: *May amounts held in a SIMPLE IRA be withdrawn at any time?*

A. F-2: Yes. An employer may not require an employee to retain any portion of the contributions in his or her SIMPLE IRA or otherwise impose any withdrawal restrictions.

G. Employer Administrative and Notification Requirements

Q. G-1: *What notification requirements apply to employers?*

Key Point + A. G-1: An employer must notify each employee, immediately before the employee's 60-day election period described in Q&A E-1, of the employee's opportunity to enter into a salary reduction agreement or to modify a prior agreement. If applicable, this notification must disclose an employee's ability to select the financial institution that will serve as the trustee of the employee's SIMPLE IRA as described in Q&A E-4. In the case of a SIMPLE IRA Plan established using Form 5304-SIMPLE (Not subject to the Designated Financial Institution Rules), the employer may use the Model Notification to Eligible Employees on page 3 of the form to disclose to each employee the employee's right to select the financial institution that will serve as the trustee of the employee's SIMPLE IRA as described in Q&A E-4. The notification must also include the summary description described in Q&A H-1. In the case of a SIMPLE IRA Plan established using Form 5304-SIMPLE (Not Subject to the Designated Financial Institution Rules) or Form 5305-SIMPLE (for Use With a Designated Financial Institution), the summary description requirement may be satisfied by providing a completed copy of pages 1 and 2 of the form that reflects the terms of the employer's plan (including the materials provided by the trustee for completion of Article VI).

Q. G-2: *May the notifications regarding a reduced matching contribution (described in Q&A D-5) and a nonelective contribution in lieu of a matching contribution (described in Q&A D-6) be provided at the same time as the notification of an employee's opportunity to enter into a salary reduction agreement and the summary description?*

A. G-2: Yes. An employer is deemed to provide the notification regarding a reduced matching contribution or a nonelective contribution in lieu of a matching contribution within a reasonable period of time before the 60-day election period if, immediately before the 60-day election period, this notification is included with the notification of an employee's opportunity to enter into a salary reduction agreement.

Q. G-3: *What reporting penalties under the code apply if an employer fails to provide one or more of the required notices?*

A. G-3: If the employer fails to provide one or more of the required notices described in Q&A G-1, the employer will be liable, under the Code, for a penalty of $50 per day until the notices are provided. If the employer shows that the failure was due to reasonable cause, the penalty will not be imposed. To the extent that each employee is permitted to select the trustee for his or her SIMPLE IRA pursuant to

Q&A E-4, and is so notified in accordance with Q&A G-1, and the information with respect to the trustee (the name and address of the trustee and its withdrawal procedures) is not available at the time the employer is required to provide the summary description, the employer is deemed to have shown reasonable cause for failure to provide this information to eligible employees, but only if the employer sees to it that this information is provided to the employee as soon as administratively feasible once the trustee has been selected.

Q. G-4: *What if an eligible employee is unwilling or unable to establish a SIMPLE IRA?*

A. G-4: If an eligible employee who is entitled to a contribution under a SIMPLE IRA Plan is unwilling or unable to establish a SIMPLE IRA with any financial institution prior to the date on which the contribution is required to be made to the SIMPLE IRA of the employee under Q&A G-5 or G-6, an employer may execute the necessary documents to establish a SIMPLE IRA on the employee's behalf with a financial institution selected by the employer.

Q. G-5: *When must an employer make salary reduction contributions under a SIMPLE IRA Plan?*

Key Point + A. G-5: The employer must make salary reduction contributions to the financial institution maintaining the SIMPLE IRA no later than the close of the 30-day period following the last day of the month in which amounts would otherwise have been payable to the employee in cash. The Department of Labor has indicated that most SIMPLE IRA Plans are also subject to Title I of ERISA, and under Department of Labor regulations, at 29 CFR 2510.3-102, salary reduction contributions to these plans must be made to the SIMPLE IRA as of the earliest date on which the contributions can reasonably be segregated from the employer's general assets, but in no event later than the 30-day deadline described above.

Q. G-6: *When must an employer make matching and nonelective contributions under a SIMPLE IRA Plan?*

A. G-6: Matching and nonelective employer contributions must be made to the financial institution maintaining the SIMPLE IRA no later than the due date for filing the employer's income tax return, including extensions, for the taxable year that includes the last day of the calendar year for which the contributions are made.

I. Tax Treatment of SIMPLE IRA Plans

Q. I-1: *What are the tax consequences of SIMPLE IRA Plan contributions?*

Key Point + A. I-1: Contributions to a SIMPLE IRA are excludable from federal income tax and not subject to federal income tax withholding. Salary reduction contributions to a SIMPLE IRA are subject to tax under the Federal Insurance Contributions Act ("FICA"), the Federal Unemployment Tax Act ("FUTA"), and the Railroad Retirement Act ("RRTA"), and must be reported on Form W-2, Wage and Tax Statement. Matching and nonelective contributions to a SIMPLE IRA are not subject to FICA, FUTA, or RRTA taxes, and are not required to be reported on Form W-2.

Q. I-2: *What are the tax consequences when amounts are distributed from a SIMPLE IRA?*

Key Point + A. I-2: Generally, the same tax results apply to distributions from a SIMPLE IRA as to distributions from a regular IRA (i.e., an IRA described in §408(a) or (b)). However, a special rule applies to a payment or distribution received from a SIMPLE IRA during the 2-year period beginning on the date on which the individual first participated in any SIMPLE IRA Plan maintained by the individual's employer (the "2-year period").

Under this special rule, if the additional income tax on early distributions under §72(t) applies to a distribution within this 2-year period, §72(t)(6) provides that the rate of additional tax under this special rule is increased from 10 percent to 25 percent. If one of the exceptions to application of the tax under §72(t) applies (e.g., for amounts paid after age 59 1/2, after death, or as part of a series of substantially equal payments), the exception also applies to distributions within the 2-year period and the 25-percent additional tax does not apply.

Q. I-3: *Are there any special rollover rules that apply to a distribution from a SIMPLE IRA?*

Key Point + A. I-3: Section 408(d)(3)(G) provides that the rollover provisions of §408(d)(3) apply to a distribution from a SIMPLE IRA during the 2-year period described in Q&A I-2 only if the distribution is paid into another SIMPLE IRA. Thus, a distribution from a SIMPLE IRA during that 2-year period qualifies as a rollover contribution (and thus is not includible in gross income) only if the distribution is paid into another SIMPLE IRA and satisfies the other requirements of §408(d)(3) for treatment as a rollover contribution.

Q. I-4: *Can an amount be transferred from a SIMPLE IRA to another IRA in a tax-free trustee-to-trustee transfer?*

A. I-4: During the 2-year period described in Q&A I-2, an amount in a SIMPLE IRA can be transferred to another SIMPLE IRA in a tax-free trustee-to-trustee transfer. If, during this 2-year period, an amount is paid from a SIMPLE IRA directly to the trustee of an IRA that is not a SIMPLE IRA, the payment is neither a tax-free trustee-to-trustee transfer nor a rollover contribution; the payment is a distribution from the SIMPLE IRA and a contribution to the other IRA that does not qualify as a rollover contribution. After the expiration of the 2-year period, an amount in a SIMPLE IRA can be transferred in a tax-free trustee-to-trustee transfer to an IRA that is not a SIMPLE IRA.

Q. I-5: *When does the 2-year period described in Q&A I-2 begin?*

A. I-5: The 2-year period described in Q&A I-2 begins on the first day on which contributions made by the individual's employer are deposited in the individual's SIMPLE IRA.

Q. I-6: Do the qualification rules of §401(a) apply to contributions under a SIMPLE IRA Plan?

A. I-6: None of the qualification rules of §401(a) apply to SIMPLE IRA Plans. For example, the §415 and 416 rules do not apply to contributions under a SIMPLE IRA Plan. Similarly, the §401(a)(17) limit does not apply to salary reduction contributions and matching contributions. However, as noted in Q & A D-6, the amount of compensation that may be taken into account for purposes of the 2-percent nonelective contribution is limited to the amount that may be taken into account under §401(a)(17) for the year.

Q. I-7: *What rules apply to an employer's ability to deduct contributions under a SIMPLE IRA Plan?*

Key Point + A. I-7: Pursuant to §404(m), contributions under a SIMPLE IRA Plan are deductible in the taxable year of the employer with or within which the calendar year for which contributions were made ends (without regard to the limitations of §404(a)). For example, if an employer has June 30 taxable year end, contributions under the SIMPLE IRA Plan for the calendar year 1997 (including contributions made in 1997 before June 30, 1997) are deductible in the taxable year ending June 30, 1998. Contributions will be treated as made for a particular taxable year if they are made on account of that taxable year and are made by the due date (including extensions) prescribed by law for filing the return for the taxable year.

J. Exception for Use of Designated Financial Institution

Q. J-1: *Can an employer designate a particular financial institution to which all contributions under the SIMPLE IRA Plan will be made?*

Key Point + A. J-1: Yes. In accordance with §408(p)(7), instead of making SIMPLE IRA Plan contributions to the financial institution selected by each eligible employee (see Q&A E-4), an employer may require that all contributions on behalf of all eligible employees under the SIMPLE IRA Plan be made to SIMPLE IRAs at a particular financial institution if the following requirements are met: (1) the employer and the financial institution agree that the financial institution will be a designated financial institution under §408(p)(7) ("DFI") for the SIMPLE IRA Plan; (2) the financial institution agrees that, if a participant so requests, the participant's balance will be transferred without cost or penalty to another SIMPLE IRA (or, after the 2-year period described in Q&A I-2, to any IRA) at a financial institution selected by the participant.

This Q&A J-1 is illustrated by the following examples:

Example 1: A representative of Financial Institution L approaches Employer B concerning the establishment of a SIMPLE IRA Plan. Employer B agrees to establish a SIMPLE IRA Plan for its eligible employees. Employer B would prefer to avoid writing checks to more than one financial institution on behalf of employees, and is interested in making all contributions under the SIMPLE IRA Plan to a single financial institution. Employer B and Financial Institution L agree that Financial Institution L will be a DFI and Financial Institution L agrees that, if a participant so requests, it will transfer the participant's balance, without cost or penalty, to another SIMPLE IRA (or, after the 2-year period described in Q&A I-2, to any IRA) at a financial institution selected by the participant. A SIMPLE IRA is established for each participating employee of Employer B at Financial Institution L. Each participant is provided with a written description of how and when the participant may direct that the participant's balance attributable to contributions made to Financial Institution L be transferred without cost or penalty to a SIMPLE IRA (or, after the 2-year period described in Q&A I-2, to any IRA) at another financial institution selected by the participant. Financial Institution L is a DFI, and Employer B may require that all contributions on behalf of all eligible employees be made to SIMPLE IRAs at Financial Institution L.

Example 2: A representative of Financial Institution M approaches Employer C concerning the establishment of a SIMPLE IRA Plan. Employer C invites Financial Institution M to make a presentation on its investment options for SIMPLE IRAs to Employer C's employees. Each eligible employee receives notification that the employer must permit the employee to select which financial institution will serve as the trustee of the employee's SIMPLE IRA (see Q&A G-1). All eligible employees of Employer C voluntarily select Financial Institution M to serve as the trustee of the SIMPLE IRAs to which Employer C will make all contributions on behalf of the employees. Financial Institution M is not a DFI merely because all eligible employees of Employer C selected Financial Institution M to serve as the trustee of their SIMPLE IRAs and Employer C consequently makes all contribution to Financial Institution M. Therefore, Financial Institution M is not required to transfer SIMPLE IRA balances without cost or penalty.

Example 3: Assume the same facts as Example 2, except that Employee X and Employee Y, who made salary reduction elections, failed to establish SIMPLE IRAs to receive SIMPLE IRA Plan contributions on their behalf before the first date on which Employer C is required to make a contribution to their SIMPLE IRAs. Employer C establishes SIMPLE IRAs at Financial Institution M for these employees and contributes the amount required to their accounts. Financial Institution M is not a DFI merely because Employer C establishes SIMPLE IRAs on behalf of Employee X and Employee Y while all other employees voluntarily select Financial Institution M to serve as the trustee of the SIMPLE IRAs to which Employer C will make contributions on their behalf.

Q. J-2: *May the time and manner in which a participant may transfer his or her balance without cost or penalty be limited without violating the requirements of §408(p)(7)?*

A. J-2: Yes. Section 408(p)(7) will not be violated merely because a participant is given only a reasonable period of time each year in which to transfer his or her balance without cost or penalty. A participant will be deemed to have been given a reasonable period of time in which to transfer his or her balance without cost or penalty if, for each calendar year, the participant has until the end of the 60-day period described in Q&A E-1 to request to transfer, without cost or penalty, his or her balance attributable to SIMPLE IRA Plan contributions for the calendar year following that 60-day period (or, for the year in which an employee becomes eligible to make salary reduction contributions, for the balance of that year) and subsequent calendar years.

If the time or manner in which a participant may transfer his or her balance without cost or penalty is limited, any such limitation must be disclosed as part of the written notification described in Q&A J-1. In the case of a SIMPLE IRA Plan established using Form 5305-SIMPLE, if the summary description requirement is being satisfied by providing a completed copy of pages one and two of Form 5305-SIMPLE, Article VI (Procedures for Withdrawal) must contain a clear explanation of any such limitation.

This Q&A J-2 is illustrated by the following examples:

Example 1: Employer A first establishes a SIMPLE IRA Plan effective January 1, 1998, and intends to make all contributions to Financial Institution M, which has agreed to serve as a DFI. For the 1998 calendar year, Employer A provides the 60-day election period described in Q&A E-1 beginning November 2, 1997, and notifies each participant that he or she may request that his or her balance attributable to future contributions be transferred from Financial Institution M to a SIMPLE IRA at a financial institution that the participant selects. The notification states that the transfer will be made without cost or penalty if the participant contacts Financial Institution M prior to January 1, 1998. For the 1998 calendar year, the requirements of §408(p)(7) will not be violated merely because participants are given only a 60-day period in which to request to transfer their balances without cost or penalty.

Example 2: Assume the same facts as Example 1. Participant X does not request a transfer of her balance by December 31, 1997, but requests a transfer of her current balance to another SIMPLE IRA on July 1, 1998. Participant X's current balance would not be required to be transferred without cost or penalty because Participant X did not request such a transfer prior to January 1, 1998. However, during the 60-day period preceding the 1999 calendar year, Participant X may request a transfer, without cost or penalty, of her balance attributable to contributions made for the 1999 calendar year and, if she so elects, for all future calendar years (but not her balance attributable to contributions for the 1998 calendar year).

Example 3: Assume the same facts as Example 1. Under the terms of the SIMPLE IRA Plan, participant Y becomes an eligible employee on June 1, 1998, and, for Participant Y, the 60-day period described in Q&A E-1 begins on that date. For the 1998 calendar year, Participant Y will be deemed to have been given a reasonable amount of time in which to request to transfer, without cost or penalty, his balance attributable to contributions for the balance of the 1998 calendar year if Financial Institution M allowed such a request to be made prior to July 31, 1998.

Q. J-3: *Is there a limit on the frequency with which a participant's balance must be transferred without cost or penalty?*

A. J-3: In order to satisfy §408(p)(7), if a participant acts, within applicable reasonable time limits, if any, to request a transfer of his or her balance, the participant's balance must be transferred on a reasonably frequent basis. A participant's balance will be deemed to be transferred on a reasonably frequent basis if it is transferred on a monthly basis.

Q. J-4: *How does a DFI transfer a participant's balance without cost or penalty?*

A. J-4: In order to satisfy §408(p)(7), a participant's balance must be transferred in a trustee-to-trustee transfer directly to a SIMPLE IRA (or, after the 2-year period described in Q&A I-2, to any IRA) at the financial institution specified by the participant.

A transfer is deemed to be made without cost or penalty if no liquidation, transaction, redemption or termination fee, or any commission, load (whether front-end or back-end) or surrender charge, or similar fee or charge is imposed with respect to the balance being transferred. A transfer will not fail to be made without cost or penalty merely because contributions that a participant has elected to have transferred without cost or penalty are required to be invested in one specified investment option until transferred, even though a variety of investment options are available with respect to contributions that participants have not elected to transfer.

This Q&A J-4 is illustrated by the following examples:

Example 1: Financial Institution Q agrees to be a DFI for the SIMPLE IRA Plan maintained by Employer D. Employer D provides the 60-day election period described in Q&A E-1 beginning on November 2 of each year and each participant is notified that he or she may request, before the end of the 60-day period, a transfer of his or her future contributions from Financial Institution Q without cost or penalty to a SIMPLE IRA (or, after the 2-year period described in Q&A I-2), to any IRA at a financial institution selected by the participant. The notification states that a participant's contributions that are to be transferred without cost or penalty will be invested in a special investment option and will be transferred to the financial institution selected by the participant on a monthly basis.

Financial Institution Q offers various investment options to account holders of SIMPLE IRA accounts, including investment options with a sales charge. Any participant who does not elect to have his or her balance transferred to another financial institution may invest the contributions made on his or her behalf in any investment option available to account holders of SIMPLE IRA accounts at Financial Institution Q. However, contributions that a participant has elected to have transferred are automatically invested, prior to transfer, in a specified investment option that has no sales charge. The requirement that a participant's balance be transferred without cost or penalty will not be violated merely because contributions that have been designated to be transferred pursuant to a participant's election are automatically invested in one specified investment option and transferred on a monthly basis to the financial institution selected by the participant.

Example 2: Assume the same facts as in Example 1. Financial Institution Q generally charges its IRA accounts a reasonable annual administration fee. Financial Institution Q also charges this annual administration fee with respect to SIMPLE IRA accounts, including SIMPLE IRA accounts from which balances must be transferred in accordance with participant's transfer elections. The requirement that participants balances be transferred without cost or penalty will not be violated merely because a reasonable annual administration fee is charged to SIMPLE IRA accounts from which balances must be transferred in accordance with participants' transfer elections.

Q. J-5: *Is the "without cost or penalty" requirement violated if a DFI charges an employer for a participant's transfer of his or her balance?*

A. J-5: The "without cost or penalty" requirement of §408(p)(7) is not violated merely because a DFI charges an employer an amount that takes into account the financial institution's responsibility to transfer balances upon a participant's request or otherwise charges an employer for a transfer requested by a participant, provided that the charge is not passed through to the participant who requests the transfer.

K. SIMPLE IRA Plan Establishment

Q. K-1: *Must an employer establish a SIMPLE IRA Plan on January 1?*

Key Point + A. K-1: An existing employer may establish a SIMPLE IRA Plan effective on any date between January 1 and October 1 of a year beginning after December 31, 1996, provided that the employer (or any predecessor employer) did not previously maintain a SIMPLE IRA Plan. This requirement does not apply to a new employer that comes into existence after October 1 of the year the SIMPLE IRA Plan is established if the employer establishes the SIMPLE IRA Plan as soon as administratively feasible after the employer comes into existence. If an employer (or predecessor employer) previously maintained a SIMPLE IRA Plan, the employer may establish a SIMPLE IRA Plan effective only on January 1 of a year.

Q. K-2: *When must a SIMPLE IRA be established for an employee?*

Key Point + A. K-2: A SIMPLE IRA is required to be established for an employee prior to the first date by which a contribution is required to be deposited into the employee's SIMPLE IRA (see Q&As G-5 and G-6).

Q. K-3: *Has the Service issued model forms that an employer can use to establish a SIMPLE IRA Plan?*

A. K-3: Yes. On October 31, 1996, the Service issued Form 5305-SIMPLE (for Use With a Designated Financial Institution), which is a form that may be used by an employer establishing a SIMPLE IRA Plan with a financial institution that is a DFI. On December 30, 1996, the Service issued Form 5304-SIMPLE (Not Subject to the Designated Financial Institution Rules), which is the model form that may be used by an employer to establish a SIMPLE IRA Plan that does not use a DFI.

Q. K-4: *How long may an employer use the modified Form 5305-SIMPLE (for Use With a Designated Financial Institution)?*

A. K-4: An employer that established or establishes a SIMPLE IRA Plan (that does not use a DFI) by using Form 5305-SIMPLE (for Use With a Designated Financial Institution) as modified in accordance with Q&A K-3 as it originally appeared in Notice 97-6 may continue to use that modified form through the end of 1998. The Service has not approved the use of the modified form beyond 1998. Consequently, such an employer that makes contributions for a calendar year after 1998 must adopt one of the two model forms (Form 5304-SIMPLE or Form 5305-SIMPLE) or an approved prototype SIMPLE IRA Plan in order to rely on Service-approved SIMPLE IRA Plans for 1999 and future years. For purposes of Q&As E-4, G-1 and H-1 of this notice, the modified Form 5305-SIMPLE is treated as a Form 5304-SIMPLE (Not Subject to the Designated Financial Institution Rules).

Effect on Other Documents. This notice modifies and supersedes Notice 97-6.

SIMPLE 401(k) PLAN

A SIMPLE plan can be adopted as part of a 401(k) plan. A SIMPLE 401(k) plan generally must satisfy the rules that apply to all 401(k) plans, subject to §415 limitations. However, contributions and benefits under a SIMPLE plan will be considered not to discriminate in favor of highly compensated employees provided the plan meets the conditions listed below.

1. Under the plan, an employee can elect to have the employer make elective deferrals for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not to exceed $6,000 for 1998.
2. The employer is required to make either:
   a. A matching contribution not to exceed 3% of compensation for the year, or
   b. Nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from the employer for the year.
3. No other contributions can be made to the trust.
4. No contributions are made, and no benefits accrue, for services during the year under any other qualified retirement plan of the employer on behalf of any employee eligible to participate in the SIMPLE plan.
5. The employee's rights to any contributions are nonforfeitable.

Top-heavy plan exception. A SIMPLE 401(k) plan that allows only contributions meeting the conditions listed above will not be treated as a top-heavy plan.

Employee notification. The notification rules that apply to SIMPLE IRA plans also apply to SIMPLE 401(k).

Model amendment. **Rev. Proc.** 97-9 contains a model amendment that may be used by employers in adopting a 401(k) plan that contains 401(k) SIMPLE provisions.

Please Note

For most states, other than Illinois, **Chapter 14, Individual and Small Business Problems** (pages 597–644) is in a separately stitched chapter that will accompany your **Book. The next page in your Tax Book will be page 649.**

Form **8857** (March 1998) Department of the Treasury Internal Revenue Service

Request for Innocent Spouse Relief

▶ See instructions.

OMB No. 1545-1596

Name of person requesting innocent spouse relief	Social security number (SSN)
Your current home address (number and street). If a P.O. box, see instructions.	Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, see instructions.	

Part I **Information About the Joint Tax Return for Which You Are Requesting Innocent Spouse Relief**

1 Enter the tax year for which you are requesting innocent spouse relief ▶ ____________

2 Enter the names and SSNs for you and your spouse from the joint tax return for the year entered on line 1.

First name, initial, and last name shown first on the joint return	SSN shown first
First name, initial, and last name shown second on the joint return	SSN shown second

Tip: *The IRS can help you complete Form 8857. If you are in contact with an IRS employee, you can ask that employee. Or you can call 1-800-829-1040.*

Caution: *By law, if the amount of additional tax due to the grossly erroneous item(s) of your spouse is* ***$500 or less****, you will not qualify for innocent spouse relief. The IRS will calculate the amount of additional tax and tell you if you qualify for innocent spouse relief.*

3	**Brief description of grossly erroneous item** (see instructions)	**Amount**
a		
b		
c		

If you have more than 3 items, attach a statement listing the additional items and amounts.

4 If line 3 includes entries for a deduction, credit, or property basis claimed on the joint return, enter **your** adjusted gross income from the **most recent tax year** (see instructions) . . . . 4 ______

ALL FILERS

NEXT: See instructions and prepare a **statement** to attach to Form 8857. Explain **why you believe you qualify** for innocent spouse relief. Include the following in the statement:

- A detailed description of each grossly erroneous item.
- Why you did not know, and had no reason to know, that there was an understatement of tax on the joint return due to the grossly erroneous item(s) of your spouse.
- Why it would be **unfair** to hold you responsible for the understated tax.

THEN: File Form 8857 as indicated in the instructions. The IRS will review your request and tell you if you qualify for innocent spouse relief.

Part II Signature(s)

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules and statements and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy of this form for your records.	▶ Signature of person requesting innocent spouse relief		Date	Daytime phone number (optional)
Paid Preparer's Use Only	Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN
	Firm's name (or yours if self-employed) and address ▶			EIN
				ZIP code

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Why Should I Use Form 8857?

You should use Form 8857 if you believe you should not be required to pay tax, interest, and penalties due for a tax year for which you filed a joint tax return. These instructions will help you determine if you should use Form 8857.

Generally, when you file a joint tax return, both you and your spouse are responsible for all the tax and any interest and penalties for that tax year. This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. However, the return may not have shown the correct tax because, for example, of income your spouse received but did not report. If you believe you should not be responsible for the additional tax, interest, and penalties, you can ask the IRS to relieve you of that responsibility. That "relief" is called **innocent spouse relief.**

Note: *If you are unsure but think you may qualify, file Form 8857. The IRS will review the form and attachments, calculate tax, and let you know if you qualify.*

If you want more details on how to calculate the tax and determine if you qualify, see **Pub. 971,** Innocent Spouse Relief.

Do I Qualify for Innocent Spouse Relief?

You must meet **all three** of the following conditions to qualify for innocent spouse relief.

Condition 1. You filed a joint return that had **grossly erroneous items** (defined later) that resulted in a **substantial understatement of tax** (defined later) shown on the return.

Condition 2. You establish that when you signed the joint return you did not know, and had no reason to know, that there was a substantial understatement of tax.

Condition 3. Considering all the facts and circumstances, it would be **unfair** to hold you responsible for the understatement of tax and related penalties and interest.

One factor in determining that it is **unfair** to hold you responsible is the absence of any significant direct or indirect benefit to you from the understatement of tax. Your receipt of property from your spouse may be a significant benefit, even if it is received several years later. Normal support received from your spouse is not a significant benefit. Another factor may be whether you were later divorced or deserted by your spouse.

Example. You filed a joint return with your spouse for 1995, but you were divorced later in 1996. The IRS is now billing you for $2,000 in additional tax and penalties on your 1995 return. The additional tax resulted from $6,000 of income from your spouse's business that was not reported on your joint tax return. You were not aware of this income and had no reason to know about it because of the way your spouse conducted the business. You also had no access to the money because your spouse did not use the money until after the divorce. You believe it would be unfair to make you pay the tax because you did not benefit from the unreported income. You may qualify for innocent spouse relief and should request it on Form 8857.

What Does NOT Qualify for Innocent Spouse Relief?

There are many situations in which you may owe tax related to your spouse, but not be eligible for innocent spouse relief. For example, you filed a joint return that properly reflects your income and deductions, but showed an unpaid balance due of $10,000, which your spouse promised to pay. You got divorced shortly thereafter, and again your spouse promised to pay the unpaid amount, but failed to do so. You are not eligible for innocent spouse relief. The law does not provide relief for an unpaid balance due shown on a return.

What Are Grossly Erroneous Items?

A grossly erroneous item is—

- **Unreported income.** Income received by your spouse that is not reported on the joint tax return, or
- **Incorrect deductions, credits, etc.** A deduction, credit, or property basis claimed on the joint return by your spouse for which there is no basis in fact or law.

For example, there is no basis in fact or law for a deduction if **any** of the three following conditions apply.

Condition 1. The expense for which the deduction is taken was never made. (For example, your spouse deducted $10,000 of advertising expenses on Schedule C (Form 1040), but never paid for any advertising.)

Condition 2. The expense does not qualify as a deductible expense under well-settled legal principles. (For example, your spouse claimed a business fees deduction of $10,000 that was for the payment of state fines; fines are not deductible.)

Condition 3. No substantial legal argument can be made to support the deductibility of the expense. (For example, your spouse claimed $4,000 security costs related to a home office, which were actually veterinary and food costs for your family's two dogs.)

What Is a Substantial Understatement of Tax?

If the amount of tax due to grossly erroneous items is **more than $500,** it is considered substantial. However, tax due to incorrect deductions, credits, etc., must meet a special test (see page 3) to be treated as a substantial understatement of tax. Tax due to unreported income does not have to meet the special test.

What Special Test Applies to Tax Due to Incorrect Deductions, Credits, etc.?

To qualify for innocent spouse relief, the tax due to **incorrect deductions, credits, etc. plus** any related penalties and interest must be more than a certain amount. That amount is explained in the table below. Definitions of your adjusted gross income (AGI) and most recent tax year follow the table. If you want, you can see Pub. 971 for more details on how to determine if you meet the test. However, the IRS will review Form 8857 and determine if you meet the test.

IF your AGI for the most recent tax year was . . .	THEN the understatement of tax due to incorrect deductions, credits, etc. PLUS related penalties and interest must be more than . . .
$20,000 or less	10% of your AGI
More than $20,000	25% of your AGI

What Is My Most Recent Tax Year?

Your **most recent tax year** is the last tax year ending before the date the IRS mailed you a notice of deficiency. If the IRS did not mail you a notice of deficiency, it is the last tax year ending before you request relief.

What Is My AGI?

Generally, **your AGI** is the amount of your income, minus certain adjustments to income, for your most recent tax year. (For example, AGI is shown on line 32 of the 1997 Form 1040.) Both of the following rules apply when you figure your AGI:

- **Do not** include the AGI of the spouse with whom you filed the joint return for the year you are requesting innocent spouse relief.
- If you were married to a different spouse at the end of your most recent tax year, include your new spouse's AGI from that year. You must include it even if you did not file a joint return with your new spouse.

What About Community Property Laws?

For purposes of innocent spouse relief, community property rules **do not** apply when determining to which spouse gross income (other than gross income from property) belongs.

When Should I File Form 8857?

File Form 8857 as soon as you realize you are liable for tax due to grossly erroneous items of your spouse. The following are some of the ways you may realize you have a liability.

- An IRS examination.
- An IRS notice.
- You and your spouse file an amended return that shows additional tax due. **Attach a copy of your amended return (Form 1040X) to Form 8857.** Write "COPY" on the Form 1040X you attach to Form 8857. File Form 8857 separately from Form 1040X.
- You become aware of unreported income.

Where Do I File Form 8857?

Where you file Form 8857 depends on your situation. Read the table below to find out where you should file.

IF . . .	THEN file Form 8857 with . . .
You are meeting with an IRS employee for an examination, examination appeal, or collection.	That IRS employee.
You received an IRS notice showing unreported income or an overstated deduction.	Internal Revenue Service Center Cincinnati, OH 45999-0857 Attach a copy of the notice to Form 8857.
You received an IRS statutory notice of deficiency.	The IRS employee named in the notice of deficiency, before the end of the 90-day period specified in the notice.* Attach a copy of the notice to Form 8857.
None of the situations above apply to you.	Internal Revenue Service Center Cincinnati, OH 45999-0857

*Before the end of the 90-day period, file a petition with the Tax Court, as explained in the notice. When you do this, you will preserve your rights if the IRS is not able to properly consider your request for innocent spouse relief before the end of the 90-day period. Include the information that supports your position, and include the innocent spouse issue in your petition to the Tax Court. The time for filing with the Tax Court is not extended while the IRS is considering your request for innocent spouse relief.

How Do I Fill In Form 8857?

Tip: *The IRS can help you complete Form 8857. If you are in contact with an IRS employee, you can ask that employee. Or you can call 1-800-829-1040.*

Address

If you have a P.O. box, enter that number **only** if your post office does not deliver mail to your street address. If you have a foreign address, enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code. Please **do not** abbreviate the country name.

Line 1—Tax Year

If you are requesting relief for more than one tax year, file a separate Form 8857 for each tax year.

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Line 3—Grossly Erroneous Item(s)

Briefly describe each item and enter the amount of unreported income or incorrect deduction, credit, or property basis. For example, if you are being billed by the IRS for $2,000 in tax, interest, and penalties that resulted from your spouse not reporting $6,000 of business income, you would enter "Unreported income—Spouse's business" and the $6,000 amount on line 3a.

Line 4—AGI From Most Recent Tax Year

See **What Is My AGI?** on page 3. If you have not yet filed your return for that year, you may estimate your AGI.

What Should I Include in My Statement?

You **must** attach a statement to Form 8857 explaining why you **believe** you qualify for innocent spouse relief. Put your name, SSN, and "Form 8857" at the top of each page. The contents of the statement will vary depending on your situation, but should include the following:

- A detailed description of each grossly erroneous item.
- Why you did not know, and had no reason to know, that there was an understatement of tax resulting from the grossly erroneous item(s).
- Why it would be **unfair** to hold you responsible for the understated tax (see page 2).

Attach copies of any original documents (such as bank statements, a divorce decree, etc.) that you are using to support your request. Put your name, SSN, and "Form 8857" on each page. Keep the originals for your records.

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to determine the amount of liability, if any, of which you may be relieved. Internal Revenue Code section 6013(e) allows innocent spouse relief. If you request innocent spouse relief, you must give us the information requested on this form. Code section 6109 requires you to provide your social security number. Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. If you do not provide all the information in a timely manner, we may not be able to process your request.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Learning about the law or the form,** 13 min.; **Preparing the form,** 16 min.; and **Copying, assembling, and sending the form to the IRS,** 14 min.

If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the form to this address. Instead, see **Where Do I File Form 8857?** on page 3.