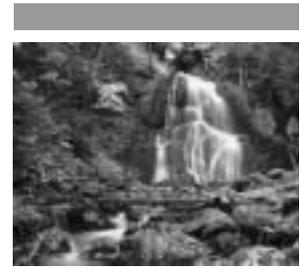




1999 Income Tax School

INDIVIDUAL AND SMALL BUSINESS PROBLEMS

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1999 Income Tax School

INDIVIDUAL AND SMALL BUSINESS PROBLEMS

PROBLEM 1: LIMITATION ON BUSINESS MEALS

Facts. Mike Rogers is an independent trucker. All of his 1999 trips are in the continental United States (CONUS). He uses the **\$38 per day optional meal allowance rule for transportation industry workers** to arrive at his allowable 1999 deduction for meals (Rev. Proc. 98-64, IRB 1998-52, p. 32; see the What's New chapter for more details).

Note. The optional meals and incidental expenses allowance amount for **1999** for transportation industry workers is \$38 per full 24-hour day. The allowance amount for **1998** was \$36 per day. These figures apply to **CONUS** travel. The daily allowance covers meals and incidental expenses (tips and laundry).

Federal employee rules allow **75%** of the full-day amount for **partial** days of travel. A taxpayer who uses this special \$38-per-day rate must use it for **all** qualifying travel in the **same** tax year.

Example. Mike left his home at 6:30 a.m. on July 12, 1999, and arrived home at 4:30 p.m. on July 17. He drove his truck to the West Coast and back.

Question 1. *How does Mike compute his optional meal and incidental expenses allowance for this trip if he uses the federal employee rules for partial travel days?*

Answer 1

Day	No. of Hours Away from Home	Allowance Amount
July 12	17½	\$ 28.50 (75% of \$38)
July 13	24	38.00
July 14	24	38.00
July 15	24	38.00
July 16	24	38.00
July 17	16½	28.50 (75% of \$38)
Total meals & incidental exp. allowance		\$209.00

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Question 2. *How much will Mike be entitled to deduct on his 1999 Schedule C for meals and incidental expenses for this trip?*

Answer 2. \$115 ($\$209 \times 55\%$).

Question 3. *What would Mike's deduction be if he left his home on July 12 at 3:00 p.m. (rather than at 6:30 a.m.) and arrived home on July 17 at 7:00 a.m. (rather than at 4:30 p.m.)?*

Answer 3. His deduction would be the same, \$115. Section 6.04(1) of Rev. Proc. 98-64 states:

For purposes of determining the amount deemed substantiated . . . **with respect to partial days of travel away from home**, either of the following methods may be used to prorate the meal and incidental expenses per diem rate for the partial days of travel:

1. Such rate may be prorated using the method prescribed by the **Federal Travel Regulations**. Currently the Federal Travel Regulations allow **three-fourths (75%)** of the applicable . . . rate for **each partial day** during which the employee **or self-employed individual** is traveling away from home . . . , or
2. Such rate may be prorated **using any method that is consistently applied and in accordance with reasonable business practice**.

Note. See the second topic in the Schedule C chapter for more information on method 2. Mike used method 1, the federal employee rules. If Mike used method 2, his deduction would be \$125 ($6 \text{ days} \times \$38 = \$228 \times 55\% = \125).

Question 4. *If Mike left home at 11:00 P.M. on July 12 and arrived home at 1:00 A.M. on July 17, would his deduction still be \$115?*

Answer 4. Yes, as **each partial day** of travel may be prorated at **75% of the \$38 daily 1999 rate** under the federal employee rules (method 1 above).

Question 5. *What taxpayers qualify as transportation workers and thus are entitled to deduct 55% of their meal expenses in 1999?*

Answer 5. Individuals subject to the Department of Transportation (DOT) hours-of-service rules, which include:

1. Certain air transportation employees such as pilots, crew, dispatchers, mechanics, and ground control operators
2. Interstate truck operators and interstate bus drivers
3. Certain railroad employees such as engineers, conductors, train crews, dispatchers, and control operations personnel
4. Certain merchant mariners

Practitioner Note. The applicable percentage for deducting meal expenses for individuals subject to the DOT rules is scheduled for the following future increases:

<u>Year</u>	<u>Applicable Percentage</u>
2000 and 2001	60%
2002 and 2003	65%
2004 and 2005	70%
2006 and 2007	75%
2008 and later years	80%

PROBLEM 2: PERCENTAGE LIMITATION RULES FOR CHARITABLE CONTRIBUTIONS

GENERAL INFORMATION

Due to the booming stock market, many practitioners may encounter this issue frequently. Many taxpayers are donating **appreciated stock** to their favorite charity instead of contributing by check. This strategy yields impressive favorable tax results and should be recommended by practitioners to many of their more generous clients. However, the donation of **appreciated stock (or other appreciated capital assets such as land)** may result in a lower **percentage limitation** on the fair market value contribution amount.

LIMITATION RULES IN BRIEF

If a taxpayer's total contributions for the tax year are **20% or less of adjusted gross income (AGI)**, the percentage limitation rules have no effect.

The percentage-of-AGI limitation may be either **20%, 30%, or 50%**, depending on the **type of property** donated and the **type of organization** to which the contribution is made.

50% Limitation Rule. The 50% limit applies to the **total of all charitable contributions made during the tax year**. The result of this limitation is that a taxpayer's **deduction for charitable contributions** (on Schedule A) **may not exceed 50% of AGI**.

50% Organizations. Most charities qualify for the maximum 50% limitation rule. These charities are often referred to as **public** charities. They include (the list is not all-inclusive):

1. Churches
2. Colleges and universities
3. Hospitals and related medical research organizations
4. Endowment foundations of state and municipal colleges and universities (**example:** University of Illinois Foundation)
5. Federal, state, or local governmental units (**example:** Burlington, Iowa, High School)
6. **Publicly supported** charitable, religious, educational, scientific, or literary organizations, **and** organizations to prevent cruelty to children or animals, **and** organizations that foster national or international sports competition (**examples:** United Way, Habitat for Humanity, USA Olympic Committee, local humane shelters, American Red Cross, American Cancer Society, local historical societies, Salvation Army, Care, Disabled American Veterans)
7. Private operating foundations (as defined by I.R.C. §509)

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Important exception to the 50% limitation rule. A 30% limitation (rather than 50%) applies to gifts of **capital gain property** (appreciated capital gain property generally) to **50% organizations** (listed above). This exception applies if the taxpayer deducts the gift at the **fair market value** figure instead of deducting the gift at the **cost basis** amount.

Note. Example 1 below demonstrates how the **30% limitation exception** is applied when appreciated stock held more than one year is donated to a 50% organization.

20% Limitation Rule. The 20% limit applies to donations of **capital gain property to private nonoperating foundations**.

Note Regarding Example 1 (which follows). Many practitioners will have clients whose financial and tax situation invites the donation of substantially appreciated stock to their favorite charities. The tax savings are significant. Appreciated stock that has split several times is an excellent candidate for a charitable contribution.

EXAMPLE 1

Facts. Chris and Anna are married. Chris is 58 and Anna is 57 as of December 31, 1998. Their net worth is over \$1 million and they have no debt. Their children are independent and financially secure. Their 1999 AGI of \$103,393 consists of the following:

Income		
Wages		\$36,429
Taxable interest		7,705
Tax-exempt interest		6,819
Ordinary dividends		11,151
Business income		2,381
Capital gain		17,052
Total IRA distributions	\$4,383	
Taxable amount		0
Total pensions and annuities	22,256	
Taxable amount		21,050
Schedule E income		9,794
Total income		\$105,562
Deductions		
IRA deduction		2,000
One-half of self-employment tax		169
Total deductions		2,169
Adjusted gross income		\$103,393

Chris and Anna come to you in March 1999, as you have prepared their returns for over 20 years. They are contemplating a large donation to their alma mater to establish a scholarship in memory of a deceased family member. They own over 3,000 shares of Coca-Cola common stock, and 2,100 of the shares were acquired in two 2-for-1 stock splits. Their split-adjusted cost basis in the 2,100 shares is about \$10 per share.

Note. They will also donate \$3,960 of cash to their church and \$135 of clothing to Goodwill in 1999.

Question 1. *What advice should you give them regarding their planned donation to their alma mater?*

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Answer 1. This is a classic example of when the donation of capital gain property (the Coca-Cola stock) should be encouraged over a cash donation. Even though Chris and Anna have significant cash assets, they should donate the stock to the college.

See the following 1999 forms and schedules and the contribution limitation worksheet from IRS Publication 526, *Charitable Contributions*, for Chris and Anna's donation of 500 shares of Coca-Cola stock to Coe College on March 5, 1999. (Additional Q & As follow.)

March 6, 1998

Coe College

Information For Deducting Your Charitable Contribution

On Your 1998 Federal Income Tax Return

=====
OFFICE OF
DEVELOPMENT

Donors: Chris and Anna Moore

Date of Transfer: March 5, 1998

Property Transferred: 500 shares of Coca Cola, Inc. common stock

High: \$69.8125

Low: \$68.375

Mean: \$69.094

Total Gift Value: 500 shares (\$69.094) = \$34,547.00

Percent of Adjusted Gross Income Ceiling Applicable to Your Gift:

Appreciated securities held long-term:

The contribution is deductible up to 30% of your adjusted gross income with a five year carryover for any "excess." Reg. Sec. 1.170A-8(d)(2)(i)(b)

- or -

Deductible up to 50% of your adjusted gross income with five year carryover for any "excess." If you make this election, all contributions of long-term property during the year and those being carried over from earlier years, must be reduced by 100% of the appreciation. Reg. Sec. 1.170A-8(b)(2)(iii)

In accordance with IRS rules, Coe College has provided no goods or services in consideration of your gift. Therefore, your gift is deductible to the full extent of the law.

Donald M. Devine

Director of Development

1999 Workbook

Form **8283**
(Rev. October 1998)

Department of the Treasury
Internal Revenue Service

Noncash Charitable Contributions

- ▶ **Attach to your tax return if you claimed a total deduction of over \$500 for all contributed property.**
▶ **See separate instructions.**

OMB No. 1545-0908

Attachment
Sequence No. **55**

Name(s) shown on your income tax return

Chris and Anna Moore

Identifying number
222 22 2222

Note: Figure the amount of your contribution deduction before completing this form. See your tax return instructions.

Section A—List in this section **only** items (or groups of similar items) for which you claimed a deduction of \$5,000 or less. Also, list certain publicly traded securities even if the deduction is over \$5,000 (see instructions).

Part I Information on Donated Property—If you need more space, attach a statement.

	(a) Name and address of the donee organization	(b) Description of donated property
1		
A	Coe College Cedar Rapids, IA 52402	500 shares of Coca Cola, Inc. common stock
B		
C		
D		
E		

Note: If the amount you claimed as a deduction for an item is \$500 or less, you do not have to complete columns (d), (e), and (f).

	(c) Date of the contribution	(d) Date acquired by donor (mo., yr.)	(e) How acquired by donor	(f) Donor's cost or adjusted basis	(g) Fair market value	(h) Method used to determine the fair market value
A	Mar. 5, 1999	May 10, 1996	stock split		34,547	Mean Value on 3/5/99
B						
C						
D						
E						

Part II Other Information—Complete line 2 if you gave less than an entire interest in property listed in Part I. Complete line 3 if conditions were attached to a contribution listed in Part I.

2 If, during the year, you contributed less than the entire interest in the property, complete lines a–e.

- a** Enter the letter from Part I that identifies the property ▶ _____. If Part II applies to more than one property, attach a separate statement.
- b** Total amount claimed as a deduction for the property listed in Part I: (1) For this tax year ▶ _____ .
(2) For any prior tax years ▶ _____ .

c Name and address of each organization to which any such contribution was made in a prior year (complete only if different from the donee organization above):

Name of charitable organization (donee)

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

d For tangible property, enter the place where the property is located or kept ▶ _____

e Name of any person, other than the donee organization, having actual possession of the property ▶ _____

3 If conditions were attached to any contribution listed in Part I, answer questions a – c and attach the required statement (see instructions).

- a** Is there a restriction, either temporary or permanent, on the donee's right to use or dispose of the donated property?
- b** Did you give to anyone (other than the donee organization or another organization participating with the donee organization in cooperative fundraising) the right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire?
- c** Is there a restriction limiting the donated property for a particular use?

	Yes	No

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Table 4. **Worksheet for Limit on Deductions** *IRS Pub 526, Charitable Contributions (Rev. March 1998)*



Who can use this worksheet. You can use this worksheet if you made charitable contributions during the year, and one or more of the limits described in this publication under *Limits on Deductions* apply to you. You cannot use this worksheet if you have a carryover of a charitable contribution from an earlier year.

General instructions:

- The terms used in this worksheet are explained earlier in this publication.
- If your answer to any line is less than zero, enter zero.
- For contributions of property, enter the property's fair market value unless you elected (or were required) to reduce the fair market value as explained under *Giving Property That Has Increased in Value*. In that case, enter the reduced amount.

Step 1. List your charitable contributions made during the year.(1999)

1. Enter your contributions to 50% limit organizations. (Include contributions of capital gain property if you reduced the property's fair market value. Do not include contributions of capital gain property deducted at fair market value.)	1	4,095
2. Enter your contributions to 50% limit organizations of capital gain property deducted at fair market value	2	34,547
3. Enter your contributions (other than of capital gain property) to qualified organizations that are not 50% limit organizations	3	0
4. Enter your contributions "for the use of" any qualified organization. (But do not enter here any amount that must be entered on line 6.)	4	0
5. Add lines 3 and 4.	5	0
6. Enter your contributions of capital gain property to or for the use of any qualified organization. (But do not enter here any amount entered on line 1 or 2.)	6	0

Step 2. Figure your deduction for the year and your carryover to the next year.

7. Enter your adjusted gross income	7	103,393
8. Multiply line 7 by 0.5. This is your 50% limit	8	51,697

Contributions to 50% limit organizations

9. Enter the smaller of line 1 or line 8.	9	4,095	
10. Subtract line 9 from line 1	10		0
11. Subtract line 9 from line 8	11	47,602	

Contributions not to 50% limit organizations

12. Add lines 1 and 2.	12	38,642	
13. Multiply line 7 by 0.3. This is your 30% limit	13	31,018	
14. Subtract line 12 from line 8	14	13,055	
15. Enter the smallest of line 5, 13, or 14	15	0	
16. Subtract line 15 from line 5	16		0
17. Subtract line 15 from line 13	17	31,018	

Contributions of capital gain property to 50% limit organizations

18. Enter the smallest of line 2, 11, or 13	18	31,018	
19. Subtract line 18 from line 2	19		3,529
20. Subtract line 15 from line 14	20	13,055	
21. Subtract line 18 from line 13	21	0	

Contributions of capital gain property not to 50% limit organizations

22. Multiply line 7 by 0.2. This is your 20% limit	22	20,679	
23. Enter the smallest of line 6, 17, 20, 21, or 22	23	0	
24. Subtract line 23 from line 6	24		0

Step 3. Summarize your deductions and carryovers.

25. Add lines 9, 15, 18, and 23. Enter the total here and on Schedule A (Form 1040)	25	35,113	
26. Add lines 10, 16, 19, and 24. Enter the total here. Carry it forward to Schedule A next year (2000)	26		3,529

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SCHEDULES A&B
(Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on Form 1040

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

1999

Attachment
Sequence No. 07

Your social security number

222 22 2222

Chris and Anna Moore

Gifts to Charity	15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-4	15	3,960		
If you made a gift and got a benefit for it, see page A-4.	16	Other than by cash or check. If any gift of \$250 or more, see page A-4. You MUST attach Form 8283 if over \$500	16	31,153		
	17	Carryover from prior year	17			
	18	Add lines 15 through 17	18			35,113

ATTACHMENT TO THE 1999 TAX RETURN

Explanation for line 16, Schedule A

1. Fair market value of used clothing given to Goodwill (50% AGI limitation item—total contributions were less than 50% of AGI)	\$ 135*
2. See Form 8283 (attached) for donation of 500 shares of Coca-Cola common stock to Coe College on March 5, 1999. Amount of contribution before the 30% of AGI limitation is \$34,547. The limitation applies. The contribution is limited to 30% of AGI, or	31,018
Line 16, Schedule A (total of items 1 and 2)	\$ 31,153

Note: The carryover to the 2000 Schedule A is \$3,529.

* This item was included as part of the \$4,095 amount on line 1 of the worksheet.

Question 2. Column (f), “Donor’s cost or adjusted basis,” in Part I Section A of Form 8283 is blank. Is this correct?

Answer 2. Yes. The instructions for Form 8283 state: “Do **not** complete this column for **publicly traded securities held 12 months or more.**”

Practitioner Note. Many colleges may complete Part IV of Section B on page 2 of Form 8283, Donee Acknowledgment (not shown in Problem 2). This apparently is **not** necessary as the instructions for Form 8283 state: “The donee organization that received **property described in Part I of Section B** must complete Part IV. However, publicly traded stock is to be omitted from Section B, the Appraisal Summary. Therefore, since publicly traded stock is not “**property described in Part I of Section B,**” it appears that Part IV, Donee Acknowledgment, should not be completed by the recipient organization.

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Question 3. *What was the amount of tax savings in Example 1 for Chris and Anna?*

Answer 3. The 1999 taxable income of Chris and Anna is \$57,467 and **their tax is \$9,375**. Without the charitable donation of the Coca-Cola stock, their taxable income would have been \$88,485 and **their tax would have been \$18,335**. The difference (\$18,335 less \$9,391) is **\$8,944**.

1999 tax savings	\$8,944
2000 estimated tax savings ($\$3,529 \times 28\%$)	<u>988</u>
Total federal tax savings from donation	\$9,932

Note. If Chris and Anna live in a state that allows charitable contributions to be deducted, they will reap additional state tax savings. In addition, they have eliminated any future capital gains on the sale of the 500 shares.

PROBLEM 3: SECTION 179 DEDUCTION

General Information. The §179 deduction increases from \$18,500 in 1998 to **\$19,000 for tax years beginning in 1999**. All taxpayers except estates, trusts, and certain noncorporate lessors may elect the I.R.C. §179 deduction for the cost of qualifying depreciable property placed in service during the tax year. Generally, property **used for lodging** and property **leased by noncorporate lessors is not** qualifying property.

An **election** must be made by the taxpayer in Part I of Form 4562 in order to properly deduct the I.R.C. §179 amount. Form 4562 must be attached to **either**:

1. An **original** (first) tax return filed for the tax year the property was placed in service, **or**
2. An **amended** return **filed by the due date (including extensions)** for the tax year the property was placed in service [Treas. Reg. §1.179-5(a)].

Note. The original return may be either a **timely filed** return or a **delinquent** return (not timely filed). The following three examples explain the **amended** return rules.

Example 1. Don timely filed his **original** 1998 Form 1040 on April 15, 1999. He failed to claim \$15,000 of an allowable §179 deduction in Part I of his 1998 Form 4562. He discovers the omission in December 1999. **Don cannot file an amended return to claim the \$15,000 deduction, as the due date of his 1998 return (including extensions) is past.**

Example 2. Carol filed Form 4868 for the automatic four-month extension for her 1998 return. She later requested and was granted an additional two-month extension until October 15, 1999, via Form 2688. She filed her 1998 return on September 20, 1999, and failed to claim \$15,000 of an allowable §179 deduction in Part I of her Form 4562. Her preparer noticed this error on October 2, 1999. **Carol can file Form 1040X by October 15, 1999, to claim the omitted \$15,000 §179 amount.**

Note for Example 3 (which follows). The conclusion reached in Example 3 is the result of the recent taxpayer-friendly Treas. Reg. §301.9100-2(b), which was issued December 30, 1997. This regulation grants taxpayers who timely file their original returns an automatic six-month extension to make tax elections required by the due date of a return including extensions. The theory behind this regulation is that taxpayers who timely file should not be penalized while taxpayers who don't may be rewarded.

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Example 3. Assume the same facts as in Example 1 above, except that Don discovered the omission on October 2, 1999. Even though Don had not requested any extensions, **he can elect the \$179 deduction on an amended return filed by October 15, 1999.** On top of the 1998 Forms 1040X and 4562 Don must write: **“Filed Pursuant to 301.9100-2.”** A private letter ruling is not required to obtain the automatic extension, and no user fees are charged.

EXAMPLE 4

Facts. Randy is a self-employed contractor who keeps his own books and records. He purchased a used truck in 1998 for \$8,000 and entered the cost as a repair. Randy furnished his accountant with his 1998 summary sheets for income and expenses. These were used to prepare Randy’s 1998 tax return.

The total shown for repairs was \$19,703, including the \$8,000 cost of the used truck. Randy’s 1998 Form 1040 was filed timely on April 15, 1999. No extensions were requested. In addition to the used truck, Randy purchased one other piece of equipment in 1998: a new concrete mixer that cost \$7,000. Randy’s 1998 Form 4562 (Part I only) is shown below.

Form 4562		Depreciation and Amortization (Including Information on Listed Property)		OMB No. 1545-0172	
Department of the Treasury Internal Revenue Service (99)		▶ See separate instructions. ▶ Attach this form to your return.		1998 Attachment Sequence No. 67	
Name(s) shown on return Randy		Business or activity to which this form relates Sch. C Concrete Contractor		Identifying number	
Part I Election To Expense Certain Tangible Property (Section 179) (Note: If you have any “listed property,” complete Part V before you complete Part I.)					
1	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions . . .	1		\$18,500	
2	Total cost of section 179 property placed in service. See page 2 of the instructions	2		7,000	
3	Threshold cost of section 179 property before reduction in limitation	3		\$200,000	
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4		0	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5		18,500	
(a) Description of property		(b) Cost (business use only)		(c) Elected cost	
6	Concrete Mixer (new)	7,000	7,000		
7	Listed property. Enter amount from line 27.	7			
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8		7,000	
9	Tentative deduction. Enter the smaller of line 5 or line 8	9		7,000	
10	Carryover of disallowed deduction from 1997. See page 3 of the instructions	10		0	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11		18,500	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11 . . .	12		7,000	
13	Carryover of disallowed deduction to 1999. Add lines 9 and 10, less line 12 ▶	13		0	

Randy’s 1998 return was examined by a revenue agent in late 2000. The agent proposed disallowance of the \$8,000 cost of the used truck that was deducted as a repair. The agent has proposed allowing an additional \$1,600 MACRS deduction on the truck.

Question 4A. *What other options are available to Randy?*

Answer 4A. None. Randy improperly deducted the \$8,000 cost of a capital item as a repair. This fact was not disclosed to his accountant, who prepared the 1998 return based on the summary sheets Randy furnished.

Question 4B. *Since Randy claimed only \$7,000 of \$179 expense on his 1998 Form 4562, and since the truck qualifies for the \$179 deduction, can he request that the revenue agent allow him an extra \$8,000 \$179 deduction for the truck?*

Answer 4B. Certainly.

Question 4C. *Will the revenue agent grant Randy’s request?*

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Answer 4C. No. See Example 1. It is too late for Randy to amend his original \$7,000 §179 election.

Question 4D. *What action could Randy's accountant have taken to prevent this IRS exam result?*

Answer 4D. The accountant could have asked Randy for an itemization of his \$19,703 repairs expense. Assuming that the accountant noticed the improper \$8,000 deduction for the truck, he could have elected to take the \$8,000 as an additional §179 deduction.

EXAMPLE 5

Facts. Carol has not yet filed her 1999 tax return when she visits your office on December 1, 2000. She asks you to prepare it. She is a self-employed interior decorator. She began the business in early 1999. Her 1999 records show the following:

Gross receipts (cash basis)	\$136,000
Expenses, not including home office computer purchase	83,000
Cost of new computer and printer acquired 1-15-99 (used 100% for business in 1999, located in her home office)	3,000

Question 5A. *May Carol elect a \$3,000 §179 deduction?*

Answer 5A. Yes. A §179 election can be properly made on a **delinquent original** return filed for the tax year in which the computer was placed in service.

Question 5B. *Is the computer considered listed property?*

Answer 5B. No. IRS Publication 946, *How to Depreciate Property* (for use in preparing 1998 returns), states: "Listed property is any computer **unless** it is used only at a regular business establishment and owned or leased by the person operating the business. A regular business establishment **includes a portion of a dwelling unit if that portion is used both regularly and exclusively for business**" [I.R.C. §280F(d)(4)(B)].

Since Carol used the computer in her qualifying home office, and since it was used **more than 50% for qualified business use**, the computer and printer are **not** listed property items. Carol's 1999 Form 4562 (Part I only) follows.

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Form **4562**

Depreciation and Amortization (Including Information on Listed Property)

OMB No. 1545-0172

Department of the Treasury
Internal Revenue Service (99)

▶ See separate instructions. ▶ Attach this form to your return.

1998

Attachment
Sequence No. **67**

Name(s) shown on return

Carol

Business or activity to which this form relates

Schedule C-Interior Decorating

Identifying number

Part I Election To Expense Certain Tangible Property (Section 179) (Note: If you have any "listed property," complete Part V before you complete Part I.)

1	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions	1	\$19,000 \$18,500
2	Total cost of section 179 property placed in service. See page 2 of the instructions	2	3,000
3	Threshold cost of section 179 property before reduction in limitation	3	\$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	19,000
(a) Description of property		(b) Cost (business use only)	(c) Elected cost
6	New Computer & Printer	3,000	3,000
7	Listed property. Enter amount from line 27.	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	3,000
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	3,000
10	Carryover of disallowed deduction from 1997. See page 3 of the instructions	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	19,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	3,000
13	Carryover of disallowed deduction to 1999. Add lines 9 and 10, less line 12 ▶	13	0

EXAMPLE 6

Facts. Sam operates an auto body repair sole proprietorship. His brother operates a similar business in another state. In 1999 Sam bought used spray-painting equipment from his brother for \$3,000. This is the only depreciable business equipment he bought in 1999. Sam's 1999 Schedule C will show a profit of \$40,000 before any §179 deduction is considered.

Question 6A. Will Sam be able to claim a §179 deduction on the used equipment he bought from his brother?

Answer 6A. Yes. Property does **not** qualify for the §179 deduction if it is acquired from a **related person**. For §179 purposes, a related person includes an individual's spouse, child, parent, other ancestor (grandparent, for example), or lineal descendant (grandchild, for example). However, a brother or a sister of the individual is **not** a related person [I.R.C. §179(d)(2)(A)].

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PLANNING CONSIDERATIONS FOR THE §179 ELECTION

1. Use the §179 election to at least partially defeat the reduced MACRS deductions mandated by the half-year and mid-quarter convention rules.

Example 7. Ed Farmer bought only one item of depreciable property for his farming business in 1999: a \$50,000 used tractor on October 10, 1999. Ed and his wife's 1999 business income (for business income limitation purposes) is \$75,000. They will file a joint 1999 return. If the §179 election is **not** made, Ed will be entitled to a **\$1,340 MACRS deduction** on the tractor (\$50,000 × .0268, from Table A-18 in IRS Publication 946—150% Declining Balance Method, Mid-Quarter Convention).

If Ed makes the §179 election on the tractor, he will be entitled to the following 1999 cost recovery deductions:

a. The maximum §179 deduction	\$19,000
b. MACRS (\$50,000 – \$19,000 × .0268)	831
Total 1999 cost recovery deduction	\$19,831

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Practitioner Note. Taxpayers must use the mid-quarter convention if the 40% test is met (the total of depreciable bases of MACRS property placed in service during the **last three months of the tax year** are **more than 40%** of the total depreciable basis of **all** MACRS property placed in service during the tax year). In determining whether the 40% test is satisfied, any §179 deduction claimed on property is **omitted** from basis.

2. Use the §179 election to maximize earned income credit.

Example 8. Carlos is a self-employed carpet installer. He is married to Yvonne. They have two children, ages 4 and 2 as of December 31, 1998. They file a joint 1998 return. Carlos bought an \$18,000 one-ton truck in June 1998 that was used 100% for business purposes. Carlos's Schedule C net profit was \$33,600 **before** any cost recovery deductions on the truck.

Scenario 1. The §179 election is not made for the truck. The allowable MACRS deduction for the truck is \$3,600 [$\$18,000 \times 20\%$ (200% declining balance method, half-year convention)]. Therefore, the 1998 Schedule C net profit is \$30,000 ($\$33,600 - \$3,600$).

In Scenario 1, the joint 1998 Form 1040 of Carlos and Yvonne will show the following:

Line 22 (total income)	\$30,000
Line 27 (1/2 of self-employment tax)	(2,120)
Line 33 (AGI)	\$27,880
Line 39 (taxable income)	9,980
Line 40 (tax)	1,496
Line 50 (self-employment tax)	4,239
Line 56 (total tax)	5,735
Line 59a (earned income credit)	467
Line 68 (amount owed—no estimated tax payments were made)	\$ 5,268

Scenario 2. The full \$18,000 cost of the truck is expensed under a §179 election. The 1998 Schedule C net profit is \$15,600 ($\$33,600$ less the §179 deduction of \$18,000).

In Scenario 2, the 1998 joint Form 1040 of Carlos and Yvonne will show the following:

Line 22 (total income)	\$15,600
Line 27 (1/2 of self-employment tax)	(1,102)
Line 33 (AGI)	\$14,498
Line 39 (taxable income)	-0-
Line 40 (tax)	-0-
Line 50 (self-employment tax)	2,204
Line 56 (total tax)	2,204
Line 59A (earned income credit)	3,290
Line 65 (overpayment)	\$ 1,086

The tax savings under Scenario 2 is \$6,354 ($\$5,268$ balance due in Scenario 1 versus a \$1,086 overpayment in Scenario 2).

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Note for Scenario 2. Because the entire \$18,000 cost of the truck was expensed under §179, the 1998 taxable income was a negative \$3,402 (AGI of \$14,498 less standard deduction of \$7,100 less exemptions (four) of \$10,800).

Therefore, instead of expensing the entire \$18,000, Carlos and Yvonne might save more tax over the 6-year MACRS recovery period (1998 through 2003) if less than the full \$18,000 were elected.

3. Make the §179 election even though the business income limitation (line 11 of Part I, Form 4562) applies.

Example 9. In 1999, Dave's Schedule C trucking business declined. It normally is very profitable. However, in 1999 the net profit before consideration of any §179 election was \$1,000. He bought a semi-tractor for \$80,000 in 1999. Even though Dave will not be able to take full advantage of the \$19,000 §179 election on that asset on his 1999 return, it should be made as shown below. This will enable Dave to carry over any unused 1999 §179 election deduction to his 2000 return where it could be used to reduce the 2000 Schedule C net profit. Part I of Dave's Form 4562 is shown below.

Form 4562	Depreciation and Amortization (Including Information on Listed Property)	OMB No. 1545-0172
Department of the Treasury Internal Revenue Service (99)	▶ See separate instructions. ▶ Attach this form to your return.	19989 Attachment Sequence No. 67
Name(s) shown on return Dave	Business or activity to which this form relates Schedule C- Trucking	Identifying number

Part I Election To Expense Certain Tangible Property (Section 179) (Note: If you have any "listed property," complete Part V before you complete Part I.)

1	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions . . .	\$19,000 \$18,500
2	Total cost of section 179 property placed in service. See page 2 of the instructions . . .	80,000
3	Threshold cost of section 179 property before reduction in limitation . . .	\$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions . . .	
6	(a) Description of property New Peterbilt Semitractor	(b) Cost (business use only) 80,000
		(c) Elected cost 19,000
7	Listed property. Enter amount from line 27.	7
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7 . . .	19,000
9	Tentative deduction. Enter the smaller of line 5 or line 8	19,000
10	Carryover of disallowed deduction from 1997. See page 3 of the instructions	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	1,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11 . . .	1,000
13	Carryover of disallowed deduction to 1999. Add lines 9 and 10, less line 12 ▶	18,000

11

PROBLEM 4: LONG-TERM CARE INSURANCE CONTRACTS

GENERAL INFORMATION

The 1996 Health Insurance Portability and Accountability Act added I.R.C. §7702B. Before enactment, the tax treatment of long-term care insurance premiums and proceeds was not clear. **Beginning in 1997, a qualified long-term care insurance contract is generally treated as an accident and health insurance contract.** Therefore, contract benefits received by the insured party are generally **excludable** as amounts received for personal injury or sickness.

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There is a **limitation** on the excludable amount received under a qualified long-term care insurance contract. In **1999** the exclusion is limited to **\$69,350**, or **\$190** per day. In **1998** the limitation amount was **\$180** per day.

Form 1099-LTC is used by insurers to report benefits paid to policyholders. **Section B** (page 2) of **Form 8853** (Medical Savings Accounts and Long-Term Care Insurance Contracts) is used by taxpayers who receive the benefits to determine the **taxable portion** (if any) of the benefits received. Any taxable portion is reported on the 1999 Form 1040, line 21 (Other income).

QUALIFIED LONG-TERM CARE SERVICES (DEFINITION)

Qualified long-term care services must meet **both** of the following two requirements:

1. They must be necessary diagnostic, preventative, therapeutic, curing, treating, mitigating, rehabilitative, or personal care services.
2. They must be **required by a chronically ill individual** and provided under a plan of care prescribed by **either** a:
 - a. Physician,
 - b. Registered professional nurse, or
 - c. Licensed social worker [I.R.C. §7702B(c)]

Note. A **chronically ill individual** is someone who has been certified (at least annually) by a licensed health practitioner (a, b, or c above) to meet **either** of the two following requirements:

1. Is unable to perform without substantial assistance **at least two daily living activities** for **at least 90 days** due to a loss of functional capacity. Daily living activities include:
 - a. Eating
 - b. Toileting
 - c. Bathing
 - d. Transferring
 - e. Dressing
 - f. Continence
2. Requires substantial supervision to protect the individual from threats to health and safety due to a **severe cognitive impairment** (**Example:** a nursing home resident who has Alzheimer's disease).

Example. Edward Lynch was certified by his physician as a **chronically ill** individual due to a disease that resulted in **severe cognitive impairment**. This written certification was made in August 1999. Edward entered a nursing home on September 26, 1999, and remained there through December 31, 1999.

He had purchased a long-term care insurance contract in 1997. The policy provided for a **\$100 per-day benefit** for any day he was a nursing home resident. The policy was a **per-diem** type policy, as the \$100 per day benefit was to be paid **without regard** to the actual nursing home expenses incurred. Edward received a 1999 Form 1099-LTC from the insurer. It is shown on the next page.

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CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Imperial Insurance Co. 703 Pawnee Road Weeping Water, NE 68463		1 Gross long-term care benefits paid \$ 6,600	OMB No. 1545-1519 1999	Long-Term Care and Accelerated Death Benefits
		2 Accelerated death benefits paid \$	Form 1099-LTC	
PAYER'S Federal identification number	POLICYHOLDER'S identification number 111-11-1111	3 <input checked="" type="checkbox"/> Per diem <input type="checkbox"/> Reimbursed amount	INSURED'S social security no. 111-11-1111	Copy B For Policyholder This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.
POLICYHOLDER'S name Edward Lynch c/o Linda Lynch Street address (including apt. no.) 102 Apple St. City, state, and ZIP code Spearfish, SD 57783		INSURED'S name Edward Lynch c/o Linda Lynch Street address (including apt. no.) 102 Apple St. City, state, and ZIP code Spearfish, SD 57783		
Account number (optional)		4 (optional) <input checked="" type="checkbox"/> Chronically ill <input type="checkbox"/> Terminally ill	Date certified 1999 08 13	

Form **1099-LTC**

(Keep for your records.)

Department of the Treasury - Internal Revenue Service

Note. The **date certified** format is mandated by IRS Notice 97-61.

Edward was in the nursing home a total of 97 days in 1999. The Imperial Insurance Company made the following benefit payments to him for the last four months of 1999:

<u>Benefits for Month of:</u>	<u>Total Benefits</u>	<u>Date Paid (Check Date)</u>
September	\$ 500 (5 × \$100)	November 5, 1999
October	3,100 (31 × \$100)	November 22, 1999
November	<u>3,000 (30 × \$100)</u>	December 22, 1999
Box 1 on 1999 Form 1099-LTC	\$ 6,600	
December	3,100 (31 × \$1,000)	January 22, 2000

Edward's nursing home expenses were \$3,800 per month plus a separate charge for laundry. Edward paid the following to No Worries Nursing Home for the last four months of 1999:

<u>For Month of:</u>	<u>Amount of Payment</u>	<u>Date Paid</u>
September	\$ 633 (5 days)	September 26, 1999
October	3,804 (incl. Sept. laundry fee)	October 16, 1999
November	3,816 (incl. Oct. laundry fee)	November 16, 1999
December	<u>3,824 (incl. Nov. laundry fee)</u>	December 16, 1999
Total 1999 payments	\$12,077	

The premiums Edward paid to Imperial Insurance Company in 1999 for the long-term care policy totaled \$2,500. Edward is 58 years old as of December 31, 1999. The completed 1999 Form 8853 (Section B only) is shown below.

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Name of policyholder (as shown on Form 1040)

Edward Lynch

Social security number of policyholder ▶

111 | 11 | 1111

Section C. Long-Term Care (LTC) Insurance Contracts—See the instructions, including Filing Requirements for Section C on page 6, before completing this section.

If more than one Section C is attached, check here ▶

16a Name of insured ▶ **Edward Lynch** **b** Social security number of insured ▶ **111 | 11 | 1111**

17 Are there individuals other than you who received payments on a per diem or other periodic basis in 1999 under a qualified LTC insurance contract, or received accelerated death benefits in 1999 under a life insurance policy, covering the insured listed on line 16a above? Yes No

18 Was the insured a terminally ill individual? Yes No
Note: If "Yes," and if the **only** payments you received during the year were accelerated death benefits received because the insured was terminally ill, skip lines 19 through 27 and enter -0- on line 28.

19 Gross LTC payments received on a per diem or other periodic basis. Enter the total amounts from box 1 of all Forms 1099-LTC that you received with respect to the insured listed on line 16a above if the "Per diem" box is checked in box 3 of Form 1099-LTC

Caution: Do **not** use lines 20 through 28 below to figure the taxable amount of benefits paid under any LTC insurance contract other than a **qualified** LTC insurance contract. Instead, to the extent these amounts are **not** excludable from your income under the applicable provisions of the Internal Revenue Code (for example, if the benefits are not paid for personal injuries or sickness through accident or health insurance), report these amounts directly on Form 1040, line 21.

20 Enter the portion of the amount you entered on line 19 that is from **qualified** LTC insurance contracts

21 Accelerated death benefits received on a per diem or other periodic basis.
Note: If you checked the "Yes" box in question 18 above, do not include on line 21 amounts received because the insured was terminally ill. See instructions

22 Add lines 20 and 21

Note: If you checked "Yes" to the question on line 17 above, see the instructions for line 17 before completing lines 23 through 27.

23 Multiply \$190 by the number of days of the LTC period

24 Enter the costs incurred for qualified LTC services provided for the insured during the LTC period (see instructions)

25 Enter the larger of line 23 or line 24

26 Enter total reimbursements received for qualified LTC services provided for the insured during the LTC period

Caution: If you received any reimbursements from LTC contracts issued before August 1, 1996, see instructions.

27 Per diem limitation. Subtract line 26 from line 25

28 **Taxable payments.** Subtract line 27 from line 22. Enter the result but do not enter less than zero. If the result is more than zero, also include it in the total on Form 1040, line 21. On the dotted line next to line 21, enter "LTC" and the amount

19		6,600
20		6,600
21		
22		6,600
23	12,540	
24	8,253	
25	12,540	
26	0	
27		12,540
28		0

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Question 1. *Regarding line 23 on Form 8853, what is the LTC period?*

Answer 1. The instructions for Form 8853 explain two methods available to calculate the long-term care (LTC) period. In most cases, the **contract period** method will be used. That is the method Edward used to compute the figure entered on line 23 of Form 8853.

Under this method, the **LTC period is the same period the insurance company uses under the contract to compute the benefits paid** to the insured. Edward's contract computes benefits on a **daily basis** (\$100 for every day he is in a nursing home). Therefore, the **LTC period** for line 23 of Form 8853 will correspond to the number of days for which benefits were paid in 1999.

Box 1 of the 1999 Form 1099-LTC shows that Edward was paid \$6,600, or \$100 per day for 66 days in 1999. Therefore, the **LTC period** (line 23, Form 8853) is **66 days**. The amount to enter on line 23 of Form 8853 is calculated as follows: 66 days in the LTC period × \$190 (the 1999 daily limitation amount) equals **\$12,540**.

Question 2. *How is the \$8,253 figure on line 24 of Form 8853 computed?*

Answer 2. Edward paid a total of \$8,253 for **qualified long-term care services** during the LTC period of 66 days, as shown below.

<u>For Month of</u>	<u>Amount of Payment</u>	<u>Number of Days</u>
September	\$ 633	5
October	3,804	31
November	3,816	30
Line 24 total	\$8,253	66

Question 3. *How much of the 1999 long-term care benefits of \$6,600 is taxable on the joint 1999 tax return of Edward and Linda?*

Answer 3. None.

Question 4. *Will Edward and Linda be entitled to report any nursing home-related medical expenses on line 1 of the 1999 Schedule A?*

Answer 4. Yes, as shown below.

Qualified long-term care premiums (limited - see Note 1 below)	\$ 800
Unreimbursed nursing home expenses (see Note 2 below)	2,377
Amount to be included on line 1 of 1999 Schedule A	\$ 3,177

Note 1. The deduction for qualified long-term care contract premiums as **medical expenses on Schedule A** is limited. The premium deduction limitation for 1999 is shown in the chart below (Rev. Proc. 98-61, §3.09).

<u>Age of Insured as of December 31, 1999</u>	<u>Premium Deduction Limit</u>
Age 40 or less	\$ 210
Age 41 to 50	400
Age 51 to 60	800
Age 61 to 70	2,120
Age 71 and above	2,660

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Note 2. \$2,377 of unreimbursed nursing home expenses should be included in the total for line 1, Schedule A, as shown below.

Line 24, Form 8853	\$ 8,253
Less: Line 19, Form 8853	(6,600)
Plus: Edward's December nursing home expenses paid on December 16, 1999	3,824
Less: Expected insurance reimbursement for Edward's December nursing home expenses	(3,100)
Total to be included on line 1, Schedule A	\$ 2,377

Practitioner Note. Many taxpayers who received 1997 and/or 1998 Forms 1099-LTC have received or will receive CP 2000 notices (underreport program) from IRS service centers. If your client receives such a notice, prepare Form 8853 and return it with the notice to the service center.

PROBLEM 5: EMPLOYEE STOCK OPTIONS

GENERAL INFORMATION

Corporations are increasingly using the provisions of I.R.C. §422 (incentive stock options) as an attractive fringe benefit. Incentive stock options were sanctioned by the Economic Recovery Tax Act (ERTA) of 1981. Due to the bull market of the 1990s, more employees at all levels of compensation are taking advantage of I.R.C. §422.

An incentive stock option (ISO) is referred to as a **statutory** stock option. The granting of an ISO by the corporation to an employee does not generate a taxable event to the employee. **The employee will report taxable income when the stock purchased by the exercise of the ISO is sold.**

An incentive stock option plan allows the employee the right to buy a fixed number of shares of his or her employer's stock at a set price (the **grant price**) for a certain number of years. The **grant price** is normally the fair market value (market price) of the employer's stock at the time the option is granted. At a later time, the employee can **exercise** his or her option by purchasing the stock at the lower **grant price** and selling the shares at the higher market price.

Employers are required to issue tax-related information to employees who exercise ISOs. However, due to the technical and procedural aspects of selling employer's stock acquired by exercising an ISO, the actual reporting of the resulting gain on the sale of such stock can be confusing.

Tax treatment rules. Employees will treat the gain on the sale of ISO stock as capital gain **unless** the employee does not hold the ISO stock for the required period. The **required holding period** for obtaining the favorable capital gain treatment for employer's stock acquired by exercising an ISO is:

- **More** than 2 years after the ISO was granted (the grant date), **and**
- **More** than one year after the stock was actually acquired by exercise of the incentive stock option (the exercise date) (Temp. Reg. §14a.422A-1, A-2).

Example 1. Holding period met with the resulting gain afforded capital gain treatment

Sally's employer, Corporation X, granted her an ISO on March 10, 1997, to buy 100 shares of its stock for \$30 per share, its market value at the time. Sally exercised the ISO and acquired the 100 shares on October 15, 1997, when the open-market value of the stock was \$45 per share.

Sally sold the 100 shares on December 20, 1999, for \$50 per share. Assume Sally had no expenses of sale. Her **gain is \$2,000 [sales price of \$5,000 (100 shares at \$50 per share) less her cost of \$3,000 (100 shares at \$30 per share, the exercise price granted by the ISO)]**.

Sally's \$2,000 gain on the sale of the stock will be a long-term capital gain on her 1999 Schedule D, as the date of sale of the stock (December 20, 1999) is **both**:

- **More** than 2 years after the ISO was granted on March 10, 1997, and
- **More** than 1 year after the stock was acquired by the exercise of the ISO on October 15, 1997.

If the holding-period rules of §422 are not met, the employee will recognize **compensation income** in the year the stock acquired by the exercise of the ISO is sold. **The compensation income is the amount by which the stock's fair market value, as of the date the ISO is exercised, exceeds the option (grant) price.** However, the compensation income **cannot** be more than the gain on the sale. If the gain on the sale of the stock **exceeds** the amount of **compensation income**, the balance of the gain is a capital gain and will be reported on Schedule D.

Practitioner Note. The amount of compensation income included in box 1 of Form W-2 is the gain before expenses of sale are considered. Therefore, the expenses of sale will equal the capital loss shown on Schedule D.

Example 2. Holding period not met and all or a portion of the resulting gain treated as compensation income.

Reid Dolly is an employee of GTE Corporation. He was granted an ISO by GTE. Following are the facts regarding the ISO:

<u>Grant Date</u>	<u>Grant Price per Share</u>	<u>Exercise Date</u>	<u>No. of Shares Exercised</u>	<u>Date of Sale</u>
11-6-97	\$42.625	11-20-98	100	11-20-98
<u>Sales Price per Share</u>	<u>Gross Sales Price</u>	<u>Cost</u>	<u>Gross Gain before Expenses of Sale</u>	<u>Expenses of Sale</u>
\$62.8125	\$6,281.25	\$4,262.50	\$2,018.75	\$16.21
<u>Compensation Income Reported on 1998 W-2</u>	<u>1998 Schedule D Short-Term Capital Loss (equal to Expenses of Sale)</u>			
\$2,018.75	(\$16.21)			

See the following documents relating to Mr. Dolly's incentive stock option from his employer, GTE Corp.

1. 1998 Form 1099-B from the brokerage firm that handled the sale of the 100 shares of GTE stock acquired by Mr. Dolly's exercise of the ISO. **Note.** The brokerage firm was selected by GTE to act as the program administrator for GTE's incentive stock option plan.
2. Confirmation slip from the brokerage firm regarding the sale of the 100 shares of GTE stock on November 20, 1998.
3. Mr. Dolly's 1998 W-2 Form from GTE. **Note.** The compensation income of \$2,018.75 is included in the total figures shown for box 1, Wages (\$88,719.83), and for box 5, Medicare wages (\$98,719.83). It would also be included in box 3 if Social Security wages were not already

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at the maximum. Medicare wages of \$98,719.83 are \$10,000 greater than the box 1 wages due to Mr. Dolly's elective deferral to his section 401 (k) plan. See box 13 of the W-2 form for this deferral (Code D) information.

4. The 1998 Schedule D for Mr. and Mrs. Dolly. **Note.** The \$16.21 short-term capital loss on the sale of the 100 shares of GTE stock is equal to the expenses of sale shown on the confirmation slip, which are:

Commission	\$ 8.00
Transaction fee	4.00
SEC fee	.21
Exercise fee	4.00
Total expenses of sale	\$ 16.21

5. Information provided by GTE regarding a **cashless exercise** of an ISO by a GTE employee. This information describes a hypothetical example. **Note:** Mr. Dolly's exercise of his ISO was a cashless exercise. He received the net amount (shown on the confirmation slip) of \$1,408.02 from the brokerage firm.

Practitioner Caution. For regular tax purposes, no income is recognized in the taxable year an ISO is exercised. **However, this rule does not apply for alternative minimum tax (AMT) purposes.** Instead, taxpayers must include as an adjustment on line 10 (Incentive stock options) of Form 6251 (Alternative Minimum Tax—Individuals) the excess, if any, of:

- The fair market value of the stock acquired through the exercise of the ISO when the rights in the stock first become transferable

less

- The amount paid for the stock (the option or grant price)

Exception. If a taxpayer acquires stock by exercising an ISO and sells the stock in the same tax year, the tax treatment for regular tax and AMT purposes is the same. No adjustment on line 10 of Form 6251 is required (Instructions for the 1998 Form 6251).

Note. Even though the exercise of an ISO may create AMT liability, a taxpayer may be able to offset the AMT in the year of exercise by future AMT credits in later tax years. Form 8801 (Credit for Prior Year Minimum Tax) is used to calculate the AMT credit in a later tax year.

SALOMON SMITH BARNEY

Member of citigroup

Form 1099 for 1998

Page: 1

Account number:

Tax ID number:



Ref: 021151
REID DOLLY
 201 LONGHORN
 PLANO TX 75093-5012

Payer

SALOMON SMITH BARNEY
 TAX REPORTING SERVICE CENTER
 388 GREENWICH ST
 NEW YORK, NY 10013

TAX ID NUMBER:

1099-B Proceeds from broker and barter transactions

(OMB No. 1545-0715)

This section shows your proceeds from security trades and tenders during the year. Gross proceeds from each trade are reported individually to the IRS after deduction of commissions. All transactions with trade dates in 1998 are reported.

Trade Date (Box 1a)	CUSIP No. (Box 1b)	Quantity	Description (Box 5)	Price	Gross Proceeds less commissions (Box 2)	Federal Income tax withheld (Box 4)
11/20/98	362320103	100.0000	GTE CORP	62.8125	\$6,265.04	
TOTALS		100.0000			\$6,265.04	

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Confirmation

SALOMON SMITH BARNEY

REID DOLLY
201 Longhorn
PLANO, TX 7509

You sold 100 at a price of 62.8125

GTE CORP
EXERCISE AND SELL

Gross Amount	\$6,281.25
<u>Total Exercise Cost</u>	<u>\$4,873.23</u>
Net Amount	\$1,408.02
Settlement Date	11/25/98

NQ Grant ID 971106
Exercise Quantity 100
Grant Price 42.6250
Option Cost 4,262.50
Gain@ 62.8125 2018.75
Federal Tax 565.25
FICA Tax2 29.27
Commission 8.00
Transaction Fee 4.00
SEC Fee .21
Exercise Fee 4.00

Trade Date: 11/20/98
Market: New York Stock Exch.

CUSIP# 362320 10 3
Security# G002838
Symbol: GTE

Unsolicited Order
Cash Acct

We acted as your agent in this transaction

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a Control number		OMB No. 1545-0008				
b Employer identification number 98 0000000		1 Wages, tips, other compensation 88,719.83		2 Federal income tax withheld 17,040.56		
c Employer's name, address, and ZIP code GTE DATA SERVICES INCORPORATED 1312 E EMPIRE STREET BLOOMINGTON IL 61701		3 Social security wages 68,400.00		4 Social security tax withheld 4,240.80		
		5 Medicare wages and tips 98,719.83		6 Medicare tax withheld 1,431.49		
		7 Social security tips		8 Allocated tips		
d Employee's social security number 123 45 6789		9 Advance EIC payment		10 Dependent care benefits		
e Employee's name, address, and ZIP code REID W DOLLY 201 Longhorn PLANO TX 75093		11 Nonqualified plans		12 Benefits included in box 1		
		13 D 10,000.00 C 457.43		14 Other HCA 1,700.00		
		15 Statutory employee <input type="checkbox"/> Deceased <input type="checkbox"/> Pension plan <input checked="" type="checkbox"/> Legal rep. <input type="checkbox"/> Deferred compensation <input checked="" type="checkbox"/>				
16 State TX	Employer's state I.D. no. 98 00000000	17 State wages, tips, etc. 3,524.37	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax

Form **W-2 Wage and Tax Statement** **1998**
Copy 1 For State, City, or Local Tax Department

Department of the Treasury—Internal Revenue Service

1999 Workbook

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on Form 1040

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

1998

Attachment
Sequence No. **12**

Your social security number
123 45 6789

Reid W. and LuAnn R. Dolly

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(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-6)	(e) Cost or other basis (see page D-6)	(f) GAIN or (LOSS) Subtract (e) from (d)
1 100 Sh.GTE Corp.	11-20-98	11-20-98	6,265.04	6,281.25	<16 21>
2 Enter your short-term totals, if any, from Schedule D-1, line 2	2				
3 Total short-term sales price amounts. Add column (d) of lines 1 and 2	3		6,265.04		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4				
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5				
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1997 Capital Loss Carryover Worksheet	6			()	
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f). ▶	7				<16 21>

CASHLESS EXERCISE

You can exercise the vested portion of your stock option and pay the exercise price (and any required tax withholding and administrative charges) without putting forward any money.

For example, let's say that you are eligible to exercise an option to purchase 50 shares of GTE Corporation common stock when the current market price per share is \$55. Here's how this exercise approach works:

Values of your stock option on the date of exercise (50 options × \$55 per share)	\$ 2,750
Grant price of your stock option (50 options × \$40 per share)	\$ 2,000
Your before-tax gain before administrative charges	\$ 750
Option cost	\$ 2,000
Estimated withholding taxes	\$ 200
Estimated administrative fees	\$ 16
Total required payment (excluding applicable administrative charges)	\$ 2,216

In this example, the administrator will send you the proceeds of \$534 (\$2,750 – \$2,216 = \$534) in the manner you instruct.

PROBLEM 6: INVESTMENT INTEREST LIMITATIONS

The Revenue Reconciliation Act of 1993 generally **excludes** net capital gain from disposition of property held for investment from investment income in the computation of the investment interest deduction limitation. This provision, effective for taxable years beginning after December 31, 1992, can reduce the current-year investment interest expense deduction and increase the carryover deduction to later years.

A taxpayer, however, can **elect** to include all or part of his or her net capital gain in investment income. If this election is made, the amount of net capital gain eligible for the 20% maximum capital gain rate must be reduced by the same amount.

The election must be made by the due date (including extensions) of the tax return on which the capital gain is reported. It is made by completing **line 4e of Form 4952**. Once made, the election may not be revoked without IRS consent.

As a general rule, an electing taxpayer should compute the final tax liability in one of two ways:

1. Claim a **lower** amount of investment interest expense deduction on Schedule A, with a resulting **higher** amount of capital gains subject to the 20% maximum rate.
2. Claim a **higher** investment interest expense deduction on Schedule A, with a resulting **lower** amount of capital gains subject to the 20% maximum rate.

Note. In the second computation, the capital gain included in investment income is subject to the regular marginal tax rate of the taxpayer. It no longer gets special capital gain treatment.

The following examples illustrate the effects of either making or not making the election for 1998.

EXAMPLE 1

Return status: Married filing jointly

Wages	\$54,000
Interest and dividend income	1,600
Capital gain distribution	1,250
<i>Itemized deductions:</i>	
State and local income taxes	1,450
Real estate taxes	2,200
Home mortgage interest	8,000
Investment interest expense (1998)	1,000
Investment interest expense c/o from 1997	5,000
Charitable contributions	600

Computation 1. Without election to treat capital gain of \$1,250 as investment income

1999 Workbook

Form **4952**
 Department of the Treasury
 Internal Revenue Service (99)

Investment Interest Expense Deduction

▶ Attach to your tax return.

OMB No. 1545-0191

1998

Attachment
 Sequence No. 72

Name(s) shown on return

Identifying number

Part I Total Investment Interest Expense

1 Investment interest expense paid or accrued in 1998. See instructions.	1	1,000	
2 Disallowed investment interest expense from 1997 Form 4952, line 7	2	5,000	
3 Total investment interest expense. Add lines 1 and 2	3	6,000	

Part II Net Investment Income

4a Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)		1,600	
b Net gain from the disposition of property held for investment	4b	1,250	
c Net capital gain from the disposition of property held for investment	4c	1,250	
d Subtract line 4c from line 4b. If zero or less, enter -0-	4d	0	
e Enter all or part of the amount on line 4c that you elect to include in investment income. Do not enter more than the amount on line 4b. See instructions ▶	4e		
f Investment income. Add lines 4a, 4d, and 4e. See instructions	4f	1,600	
5 Investment expenses. See instructions	5		
6 Net investment income. Subtract line 5 from line 4f. If zero or less, enter -0-	6	1,600	

Part III Investment Interest Expense Deduction

7 Disallowed investment interest expense to be carried forward to 1999. Subtract line 6 from line 3. If zero or less, enter -0-	7	4,400	
8 Investment interest expense deduction. Enter the smaller of line 3 or 6. See instructions.	8	1,600	

Note. Line 4e is used to make the election to include capital gains as investment income. In computation 1, the election has **not** been made, and therefore line 4e is blank.

SCHEDULES A&B
 (Form 1040)

Schedule A—Itemized Deductions

(Schedule B is on back)

OMB No. 1545-0074

1998

Attachment
 Sequence No. 07

Department of the Treasury
 Internal Revenue Service (99)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

Name(s) shown on Form 1040

Your social security number

Interest You Paid		10 Home mortgage interest and points reported to you on Form 1098	10	8,000	
(See page A-3.)		11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶			
		-----	11		
		-----	12		
Note:		12 Points not reported to you on Form 1098. See page A-3 for special rules	12		
Personal interest is not deductible.		13 Investment interest. Attach Form 4952 if required. (See page A-3.)	13	1,600	
		14 Add lines 10 through 13	14	9,600	

Schedule D (Form 1040 1998 page 2) for computation 1 is shown below:

1999 Workbook

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39	19	37,600
20	Enter the smaller of line 16 or line 17 of Schedule D	20	1,250
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21	
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	1,250
23	Combine lines 7 and 15. If zero or less, enter -0-	23	0
24	Enter the smaller of line 15 or line 23, but not less than zero	24	0
25	Enter your unrecaptured section 1250 gain, if any (see page D-7)	25	
26	Add lines 24 and 25	26	
27	Subtract line 26 from line 22. If zero or less, enter -0-	27	1,250
28	Subtract line 27 from line 19. If zero or less, enter -0-	28	36,350
29	Enter the smaller of: <ul style="list-style-type: none"> • The amount on line 19, or • \$25,350 if single; \$42,350 if married filing jointly or qualifying widow(er); \$21,175 if married filing separately; or \$33,950 if head of household 	29	37,600
30	Enter the smaller of line 28 or line 29	30	36,350
31	Subtract line 22 from line 19. If zero or less, enter -0-	31	36,350
32	Enter the larger of line 30 or line 31	32	36,350
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ▶	33	5,456
34	Enter the amount from line 29	34	37,600
35	Enter the amount from line 28	35	36,350
36	Subtract line 35 from line 34. If zero or less, enter -0-	36	1,250
37	Multiply line 36 by 10% (.10) ▶	37	125
38	Enter the smaller of line 19 or line 27	38	1,250
39	Enter the amount from line 36	39	1,250
40	Subtract line 39 from line 38	40	0
41	Multiply line 40 by 20% (.20) ▶	41	
42	Enter the smaller of line 22 or line 25	42	
43	Add lines 22 and 32	43	37,600
44	Enter the amount from line 19	44	37,600
45	Subtract line 44 from line 43. If zero or less, enter -0-	45	0
46	Subtract line 45 from line 42. If zero or less, enter -0-	46	0
47	Multiply line 46 by 25% (.25) ▶	47	
48	Enter the amount from line 19	48	37,600
49	Add lines 32, 36, 40, and 46	49	37,600
50	Subtract line 49 from line 48	50	
51	Multiply line 50 by 28% (.28) ▶	51	
52	Add lines 33, 37, 41, 47, and 51	52	5,581
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	53	5,644
54	Tax on taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40. ▶	54	5,581

Note. Line 21 is blank since the election was **not** made. The tax shown on line 54 is \$5,581. The \$1,250 capital gain is taxed at 10% since the entire capital gain is within the 15% tax bracket. The remaining taxable income of \$36,350 (\$37,600 – \$1,250) is taxed at the 15% marginal rate.

1999 Workbook

Note. The investment interest deduction is **increased** by the \$1,250 capital gain distribution elected as investment income on line 4e of Form 4952.

Schedule D (Form 1040) 1998 Page 2

Part IV Tax Computation Using Maximum Capital Gains Rates			
19	Enter your taxable income from Form 1040, line 39		19 36,350
20	Enter the smaller of line 16 or line 17 of Schedule D	20 1,250	
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21 1,250	
22	Subtract line 21 from line 20. If zero or less, enter -0-	22 0	
23	Combine lines 7 and 15. If zero or less, enter -0-	23 0	
24	Enter the smaller of line 15 or line 23, but not less than zero	24 0	
25	Enter your unrecaptured section 1250 gain, if any (see page D-7)	25	
26	Add lines 24 and 25	26	
27	Subtract line 26 from line 22. If zero or less, enter -0-	27 0	
28	Subtract line 27 from line 19. If zero or less, enter -0-	28 36,350	
29	Enter the smaller of: <ul style="list-style-type: none"> • The amount on line 19, or • \$25,350 if single; \$42,350 if married filing jointly or qualifying widow(er); \$21,175 if married filing separately; or \$33,950 if head of household 	29	36,350
30	Enter the smaller of line 28 or line 29	30 36,350	
31	Subtract line 22 from line 19. If zero or less, enter -0-	31 36,350	
32	Enter the larger of line 30 or line 31	32 36,350	
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ▶	33 5,456	
34	Enter the amount from line 29	34 36,350	
35	Enter the amount from line 28	35 36,350	
36	Subtract line 35 from line 34. If zero or less, enter -0-	36 0	
37	Multiply line 36 by 10% (.10) ▶	37 0	
38	Enter the smaller of line 19 or line 27	38 0	
39	Enter the amount from line 36	39 0	
40	Subtract line 39 from line 38	40 0	
41	Multiply line 40 by 20% (.20) ▶	41	
42	Enter the smaller of line 22 or line 25	42	
43	Add lines 22 and 32	43 36,350	
44	Enter the amount from line 19	44 36,350	
45	Subtract line 44 from line 43. If zero or less, enter -0-	45 0	
46	Subtract line 45 from line 42. If zero or less, enter -0-	46 0	
47	Multiply line 46 by 25% (.25) ▶	47	
48	Enter the amount from line 19	48 36,350	
49	Add lines 32, 36, 40, and 46	49 36,350	
50	Subtract line 49 from line 48	50	
51	Multiply line 50 by 28% (.28) ▶	51	
52	Add lines 33, 37, 41, 47, and 51	52 5,456	
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	53 5,456	
54	Tax on taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40. ▶	54 5,456	

1999 Workbook

Note. Line 21 on Schedule D reflects the election from Form 4952. The \$1,250 capital gain distribution is not afforded the 20% (10%) capital gains tax rate. **The Computation 2 tax of \$5,456 is \$125 less than the Computation 1 tax of \$5,581.** The additional itemized deduction of \$1,250 saves \$187.50 in tax ($\$1,250 \times 15\%$). The capital gain of \$1,250 is taxed at 15% instead of 10% ($5\% \times \$1,250 = \62.50).

\$187.50	Tax decrease from deduction on Schedule A
<u>62.50</u>	Tax increase from gain on Schedule D
\$125.00	Net decrease in tax resulting from the election

EXAMPLE 2

(Same facts as Example 1 except wages are \$84,000 rather than \$54,000).

Return status: Married filing jointly

Wages	\$84,000
Interest and dividend income	1,600
Capital gain distributions	1,250
<i>Itemized deductions:</i>	
State and local income taxes	2,400
Real estate taxes	2,200
Home mortgage interest	8,000
Investment interest expense (1998)	1,000
Investment interest expense c/o from 1997	5,000
Charitable contributions	600

Computation 1. Without election to treat capital gain of \$1,250 as investment income.

1999 Workbook

Form **4952**
 Department of the Treasury
 Internal Revenue Service (99)

Investment Interest Expense Deduction

▶ Attach to your tax return.

OMB No. 1545-0191

1998

Attachment
 Sequence No. 72

Name(s) shown on return

Identifying number

Part I Total Investment Interest Expense

1 Investment interest expense paid or accrued in 1998. See instructions.	1	1,000	
2 Disallowed investment interest expense from 1997 Form 4952, line 7	2	5,000	
3 Total investment interest expense. Add lines 1 and 2	3	6,000	

Part II Net Investment Income

4a Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)		1,600	
b Net gain from the disposition of property held for investment	4b	1,250	
c Net capital gain from the disposition of property held for investment	4c	1,250	
d Subtract line 4c from line 4b. If zero or less, enter -0-	4d	0	
e Enter all or part of the amount on line 4c that you elect to include in investment income. Do not enter more than the amount on line 4b. See instructions ▶	4e		
f Investment income. Add lines 4a, 4d, and 4e. See instructions	4f	1,600	
5 Investment expenses. See instructions	5		
6 Net investment income. Subtract line 5 from line 4f. If zero or less, enter -0-	6	1,600	

Part III Investment Interest Expense Deduction

7 Disallowed investment interest expense to be carried forward to 1999. Subtract line 6 from line 3. If zero or less, enter -0-	7	4,400	
8 Investment interest expense deduction. Enter the smaller of line 3 or 6. See instructions.	8	1,600	

SCHEDULES A&B
 (Form 1040)

Schedule A—Itemized Deductions

(Schedule B is on back)

Department of the Treasury
 Internal Revenue Service (99)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074

1998

Attachment
 Sequence No. 07

Name(s) shown on Form 1040

Your social security number

Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098	10	8,000	
(See page A-3.)	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶			
				
				
Note:	11				
Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules			
	13	Investment interest. Attach Form 4952 if required. (See page A-3.)		1,600	
	14	Add lines 10 through 13	14	9,600	

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1999 Workbook

Schedule D (Form 1040) 1998 Page 2

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39			66,650
20	Enter the smaller of line 16 or line 17 of Schedule D	20	1,250	
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21		
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	1,250	
23	Combine lines 7 and 15. If zero or less, enter -0-	23	0	
24	Enter the smaller of line 15 or line 23, but not less than zero	24	0	
25	Enter your unrecaptured section 1250 gain, if any (see page D-7)	25		
26	Add lines 24 and 25	26		
27	Subtract line 26 from line 22. If zero or less, enter -0-	27		1,250
28	Subtract line 27 from line 19. If zero or less, enter -0-	28		65,400
29	Enter the smaller of: <ul style="list-style-type: none"> • The amount on line 19, or • \$25,350 if single; \$42,350 if married filing jointly or qualifying widow(er); \$21,175 if married filing separately; or \$33,950 if head of household 	29		42,350
30	Enter the smaller of line 28 or line 29	30		42,350
31	Subtract line 22 from line 19. If zero or less, enter -0-	31		65,400
32	Enter the larger of line 30 or line 31	32		65,400
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ▶	33		12,814
34	Enter the amount from line 29	34		42,350
35	Enter the amount from line 28	35		65,400
36	Subtract line 35 from line 34. If zero or less, enter -0-	36		0
37	Multiply line 36 by 10% (.10) ▶	37		
38	Enter the smaller of line 19 or line 27	38		1,250
39	Enter the amount from line 36	39		
40	Subtract line 39 from line 38	40		1,250
41	Multiply line 40 by 20% (.20) ▶	41		250
42	Enter the smaller of line 22 or line 25	42		
43	Add lines 22 and 32	43	66,650	
44	Enter the amount from line 19	44	66,650	
45	Subtract line 44 from line 43. If zero or less, enter -0-	45		0
46	Subtract line 45 from line 42. If zero or less, enter -0-	46		0
47	Multiply line 46 by 25% (.25) ▶	47		
48	Enter the amount from line 19	48		66,650
49	Add lines 32, 36, 40, and 46	49		66,650
50	Subtract line 49 from line 48	50		
51	Multiply line 50 by 28% (.28) ▶	51		
52	Add lines 33, 37, 41, 47, and 51.	52		13,064
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	53		13,164
54	Tax on taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40. ▶	54		13,064

1999 Workbook

Computation 2. Making the election:

Form 4952 Department of the Treasury Internal Revenue Service (99)	<h3 style="margin: 0;">Investment Interest Expense Deduction</h3> <p style="margin: 0;">▶ Attach to your tax return.</p>	OMB No. 1545-0074 <h2 style="margin: 0;">1998</h2> Attachment Sequence No. 72
Name(s) shown on return		Identifying number

Part I Total Investment Interest Expense		
1 Investment interest expense paid or accrued in 1998. See instructions	1	1,000
2 Disallowed investment interest expense from 1997 Form 4952, line 7	2	5,000
3 Total investment interest expense. Add lines 1 and 2	3	6,000

Part II Net Investment Income		
4a Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)	4a	1,600
b Net gain from the disposition of property held for investment	4b	1,250
c Net capital gain from the disposition of property held for investment	4c	1,250
d Subtract line 4c from line 4b. If zero or less, enter -0-	4d	0
e Enter all or part of the amount on line 4c that you elect to include in investment income. Do not enter more than the amount on line 4b. See instructions ▶	4e	
f Investment income. Add lines 4a, 4d, and 4e. See instructions	4f	1,600
5 Investment expenses. See instructions	5	
6 Net investment income. Subtract line 5 from line 4f. If zero or less, enter -0-	6	1,600

Part III Investment Interest Expense Deduction		
7 Disallowed investment interest expense to be carried forward to 1999. Subtract line 6 from line 3. If zero or less, enter -0-	7	4,400
8 Investment interest expense deduction. Enter the smaller of line 3 or 6. See instructions.	8	1,600

SCHEDULES A&B (Form 1040) Department of the Treasury Internal Revenue Service (99)	<h3 style="margin: 0;">Schedule A—Itemized Deductions</h3> <p style="margin: 0;">(Schedule B is on back)</p> <p style="margin: 0;">▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).</p>	OMB No. 1545-0074 <h2 style="margin: 0;">1998</h2> Attachment Sequence No. 07
Name(s) shown on Form 1040		Your social security number

Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098	10	8,000	
(See page A-3.)	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶			
	12	Points not reported to you on Form 1098. See page A-3 for special rules			
Note: Personal interest is not deductible.	13	Investment interest. Attach Form 4952 if required. (See page A-3.)		2,850	
	14	Add lines 10 through 13	14		10,850

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1999 Workbook

Schedule D (Form 1040) 1998 Page 2

Part IV Tax Computation Using Maximum Capital Gains Rates			
19	Enter your taxable income from Form 1040, line 39		65,400
20	Enter the smaller of line 16 or line 17 of Schedule D	1,250	
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	1,250	
22	Subtract line 21 from line 20. If zero or less, enter -0-	0	
23	Combine lines 7 and 15. If zero or less, enter -0-	0	
24	Enter the smaller of line 15 or line 23, but not less than zero		
25	Enter your unrecaptured section 1250 gain, if any (see page D-7)		
26	Add lines 24 and 25		
27	Subtract line 26 from line 22. If zero or less, enter -0-		0
28	Subtract line 27 from line 19. If zero or less, enter -0-		65,400
29	Enter the smaller of: <ul style="list-style-type: none"> • The amount on line 19, or • \$25,350 if single; \$42,350 if married filing jointly or qualifying widow(er); \$21,175 if married filing separately; or \$33,950 if head of household 		42,350
30	Enter the smaller of line 28 or line 29		42,350
31	Subtract line 22 from line 19. If zero or less, enter -0-		65,400
32	Enter the larger of line 30 or line 31		65,400
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ▶		12,814
34	Enter the amount from line 29		42,350
35	Enter the amount from line 28		65,400
36	Subtract line 35 from line 34. If zero or less, enter -0-		0
37	Multiply line 36 by 10% (.10) ▶		
38	Enter the smaller of line 19 or line 27		
39	Enter the amount from line 36		
40	Subtract line 39 from line 38		0
41	Multiply line 40 by 20% (.20) ▶		
42	Enter the smaller of line 22 or line 25		
43	Add lines 22 and 32	65,400	
44	Enter the amount from line 19	65,400	
45	Subtract line 44 from line 43. If zero or less, enter -0-		0
46	Subtract line 45 from line 42. If zero or less, enter -0-		0
47	Multiply line 46 by 25% (.25) ▶		
48	Enter the amount from line 19		65,400
49	Add lines 32, 36, 40, and 46		65,400
50	Subtract line 49 from line 48		
51	Multiply line 50 by 28% (.28) ▶		
52	Add lines 33, 37, 41, 47, and 51		12,814
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies		12,814
54	Tax on taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40. ▶		12,814

Note. The decrease in tax resulting from making the election is \$250. The additional itemized deduction of \$1,250 saves \$350 in tax ($\$1,250 \times 28\%$). The \$1,250 capital gain is taxed at the 28% marginal rate instead of the 20% capital gain rate ($28\% - 20\% = 8\% \times \$1,250 = \$100$).

\$350	Tax decrease from deduction on Schedule A
100	Tax increase from gain on Schedule D
\$250	Net decrease in tax resulting from the election

Observation. The above examples illustrate that the tax savings increase as the taxpayer moves from the 15% marginal tax bracket to the 28% marginal tax bracket. It would be logical to assume that the tax savings continue to rise as the taxpayer's marginal tax bracket continues to increase. However, that is not the case. The tax savings is 20% of the amount that is subject to the election for all taxpayers in the 28% or higher tax bracket who itemize deductions. This assumes that the increase in the investment interest deduction equals the capital gain amount elected to be included in the investment income.

PROBLEM 7: MINOR CHILD WITH UNEARNED INCOME AND CAPITAL GAINS

Computing the tax liability of a dependent child under the age of 14 can be time-consuming, especially when the child has been investing in stocks and mutual funds. This problem first reviews the basics and then computes the tax liability of a child under the age of 14 with wage, interest, dividends, and capital gain income. Whether the child is a dependent is irrelevant.

Practitioner Caution. Several tax preparation software products accurately make these difficult computations. However many do not. Practitioners should determine if the products they use are able to make these computations. If not, they should be prepared for a hands-on, time-consuming computation.

THE BASICS

Part of a child's 1999 investment income may be subject to tax at the parents' tax rate if:

- The child was under age 14 on January 1, 2000, and
- The child's investment income is more than \$1,400.

Note. An **election (Form 8814)** to report the child's income on the parents' return can be made only if **all** the following conditions are met:

- The child was under age 14 on January 1, 2000.
- The child is required to file a 1999 return.
- The child had income **only** from interest and dividends.
- The child had gross income for 1999 that was less than \$7,000.
- The child had no estimated tax payments or backup withholding for 1999 (including any overpayments of tax from 1998 applied to 1999 estimated tax).

Practitioner Caution. If the **election** is made to use Form 8814, the child's capital gain distributions, if any, will be included on line 3, Form 8814. They will be taxed as ordinary income on the parents' return.

If an election is **not** made by the parents, the child's tax liability is computed on **Form 8615**. The tax is calculated in three stages:

1. Compute the child's net investment income in Part I, Form 8615.

1999 Workbook

2. Compute a tentative tax on the net investment income based on the parents' tax rate in Part II, Form 8615.
3. Compute the child's tax in Part III, Form 8615.

The complexity occurs when the child has capital gains. In that case, the election on Form 8814 **cannot** be made. Worksheets found in IRS Publication 929, *Tax Rules for Children and Dependents*, are used to compute the child's tax liability. Many of the tax preparation software programs provide these worksheets as dropdown windows when preparing Form 8615.

Example. Ed and Sherri Investwise are married and have two children. Elizabeth is 16 and Mary is 12. Sherri is a self-employed photographer. Ed is employed as a purchasing manager. In her business, Sherri paid wages of \$3,590 to each of her children. The work they performed was bona fide, and Sherri has complete documentation to support the deduction. Ed and Sherri have been gifting identical amounts to each child for the past 5 years. The gifts have been invested in identical stocks and mutual funds under each child's name and social security number. (These points are made to demonstrate the difference in tax liability on the same exact items and amounts of income for a child **age 14 or older** versus a child **under age 14**.)

Ed and Sherri's top tax bracket in 1998 is **36%**. Their 1998 taxable income is **\$201,315**, including **\$14,793** of net long-term capital gain. Their tax, as computed in Part IV (partially shown) of Schedule D, is **\$53,735**.

Ed and Sherri's 1998 forms and schedules follow.

1999 Workbook

Form **1040**

Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 1998

(99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1998, or other tax year beginning _____, 1998, ending _____, 19 _____ OMB No. 1545-0074

Label

(See instructions on page 18.)

Use the IRS

Your first name and initial <i>Ed</i>	Last name <i>Investwise</i>	Your social security number <i>333 33 3333</i>
If a joint return, spouse's first name and initial <i>Sherri</i>	Last name <i>Investwise</i>	Spouse's social security number <i>444 44 4444</i>

Exemptions

If more than six dependents, see page 19.

6a **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a.

b **Spouse**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 19)
<i>ELIZABETH N.</i>	<i>INVESTWISE</i>	<i>111 11 1111</i>		<input type="checkbox"/>
<i>MARY M.</i>	<i>INVESTWISE</i>	<i>222 22 2222</i>		<input checked="" type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>

d Total number of exemptions claimed **4**

No. of boxes checked on 6a and 6b **2**

No. of your children on 6c who:

- lived with you
- did not live with you due to divorce or separation (see page 19)

Dependents on 6c not entered above

Add numbers entered on lines above **4**

Income

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see page 20.

Enclose, but do not staple, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	113,309
8a	Taxable interest. Attach Schedule B if required	8a	1,608
9	Tax-exempt interest. DO NOT include on line 8a 8b 10	9	22,326
10	Ordinary dividends. Attach Schedule B if required	10	
11	Taxable refunds, credits, or offsets of state and local income taxes (see page 21)	11	
12	Alimony received	12	125,457
13	Business income or (loss). Attach Schedule C or C-EZ	13	14,793
14	Capital gain or (loss). Attach Schedule D	14	
15a	Other gains or (losses). Attach Form 4797	15a	
15b	Total IRA distributions	15b	
16a	Total pensions and annuities	16a	
16b	Taxable amount (see page 22)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits	20a	
20b	Taxable amount (see page 24)	20b	
21	Other income. List type and amount—see page 24	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your total income	22	277,493

Adjusted Gross Income

If line 33 is under \$30,095 (under \$10,030 if a child did not live with you), see EIC inst. on page 36.

23	IRA deduction (see page 25)	23	
24	Student loan interest deduction (see page 27)	24	
25	Medical savings account deduction. Attach Form 8853	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	5,921
28	Self-employed health insurance deduction (see page 28)	28	
29	Keogh and self-employed SEP and SIMPLE plans	29	23,907
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN	31a	
32	Add lines 23 through 31a	32	29,828
33	Subtract line 32 from line 22. This is your adjusted gross income	33	247,665

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1999 Workbook

Tax and Credits	34	Amount from line 33 (adjusted gross income)		247,665
	35a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here		
Standard Deduction for Most People Single: \$4,250 Head of household: \$6,250 Married filing jointly or Qualifying widow(er): \$7,100 Married filing separately: \$3,550	b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 29 and check here	<input type="checkbox"/>	
	36	Enter the larger of your itemized deductions from Schedule A, line 28, OR standard deduction shown on the left. But see page 30 to find your standard deduction if you checked any box on line 35a or 35b or if someone can claim you as a dependent		40,950
	37	Subtract line 36 from line 34		206,715
	38	If line 34 is \$93,400 or less, multiply \$2,700 by the total number of exemptions claimed on line 6d. If line 34 is over \$93,400, see the worksheet on page 30 for the amount to enter		5,400
	39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-		201,315
	40	Tax. See page 30. Check if any tax from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972		53,735
	41	Credit for child and dependent care expenses. Attach Form 2441	41	
	42	Credit for the elderly or the disabled. Attach Schedule R	42	
	43	Child tax credit (see page 31)	43	
	44	Education credits. Attach Form 8863	44	
	45	Adoption credit. Attach Form 8839	45	
	46	Foreign tax credit. Attach Form 1116 if required	46	190
	47	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify)	47	
	48	Add lines 41 through 47. These are your total credits	48	190
	49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0-	49	53,545
Other Taxes	50	Self-employment tax. Attach Schedule SE	50	11,842
	51	Alternative minimum tax. Attach Form 6251	51	
	52	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	52	
	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	
	56	Add lines 49 through 55. This is your total tax	56	65,387

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

1998

Attachment
Sequence No. 12

Name(s) shown on Form 1040

Ed and Sherri Investwise

Your social security number
333 33 3333

12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1.			
13	Capital gain distributions. See page D-2			
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	()	(
15	Combine lines 8 through 14 in column (g)			
16	Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Next: Go to Part III on the back.	14,793		

Schedule D (Form 1040) 1998

Page 2

Part III Summary of Parts I and II

17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 Next: Complete Form 1040 through line 39. Then, go to Part IV to figure your tax if:			14,793
54	Tax on taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40.			636

1999 Workbook

Elizabeth's 1998 forms and schedules are shown next, which include portions of her

- 1998 Form 1040, page 1
- 1998 Form 1040, page 2
- 1998 Schedule D

Form 1040		Department of the Treasury—Internal Revenue Service		1998		(99) IRS Use Only—Do not write or staple in this space.		
U.S. Individual Income Tax Return		For the year Jan. 1–Dec. 31, 1998, or other tax year beginning		, 1998, ending		, 19 OMB No. 1545-0074		
Label (See instructions)	Your first name and initial Elizabeth N.	Last name Investwise		Your social security number 111 : 11 : 1111				
Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	3,590			
	8a	Taxable interest. Attach Schedule B if required		8a	35			
		b	Tax-exempt interest. DO NOT include on line 8a	8b				
	9	Ordinary dividends. Attach Schedule B if required		9	1,395			
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 21)		10				
	11	Alimony received		11				
	12	Business income or (loss). Attach Schedule C or C-EZ		12				
	13	Capital gain or (loss). Attach Schedule D		13	4,584			
	14	Other gains or (losses). Attach Form 4797		14				
	15a	Total IRA distributions	15a		b	Taxable amount (see page 22)		
	15b			15b				
	16a	Total pensions and annuities	16a		b	Taxable amount (see page 22)		
	16b			16b				
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17				
	18	Farm income or (loss). Attach Schedule F		18				
	19	Unemployment compensation		19				
	20a	Social security benefits	20a		b	Taxable amount (see page 24)		
	20b			20b				
	21	Other income. List type and amount—see page 24		21				
	22	Add the amounts in the far right column for lines 7 through 21. This is your total income ▶		22	9,604			
	Adjusted Gross Income	23	IRA deduction (see page 25)		23			
		24	Student loan interest deduction (see page 27)		24			
25		Medical savings account deduction. Attach Form 8853		25				
26		Moving expenses. Attach Form 3903		26				
27		One-half of self-employment tax. Attach Schedule SE		27				
28		Self-employed health insurance deduction (see page 28)		28				
29		Keogh and self-employed SEP and SIMPLE plans		29				
30		Penalty on early withdrawal of savings		30				
31a		Alimony paid	b Recipient's SSN ▶	31a				
32		Add lines 23 through 31a		32				
33		Subtract line 32 from line 22. This is your adjusted gross income ▶		33	9,604			

1999 Workbook

Tax and Credits	34	Amount from line 33 (adjusted gross income)	34	9,604
	35a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here ▶ 35a		
Standard Deduction for Most People Single: \$4,250 Head of household: \$6,250 Married filing jointly or Qualifying widow(er): \$7,100 Married filing separately: \$3,550	b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 29 and check here ▶ 35b <input type="checkbox"/>		
	36	Enter the larger of your itemized deductions from Schedule A, line 28, OR standard deduction shown on the left. But see page 30 to find your standard deduction if you checked any box on line 35a or 35b or if someone can claim you as a dependent	36	3,840
	37	Subtract line 36 from line 34	37	5,764
	38	If line 34 is \$93,400 or less, multiply \$2,700 by the total number of exemptions claimed on line 6d. If line 34 is over \$93,400, see the worksheet on page 30 for the amount to enter	38	0
	39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	5,764
	40	Tax. See page 30. Check if any tax from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 ▶	40	636
	41	Credit for child and dependent care expenses. Attach Form 2441	41	
	42	Credit for the elderly or the disabled. Attach Schedule R	42	
	43	Child tax credit (see page 31)	43	
	44	Education credits. Attach Form 8863	44	
45	Adoption credit. Attach Form 8839	45		
46	Foreign tax credit. Attach Form 1116 if required	46		
47	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify) _____	47		
48	Add lines 41 through 47. These are your total credits	48		
49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0- ▶	49	636	

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)
Name(s) shown on Form 1040

Capital Gains and Losses

- ▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
- ▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB NO. 1545-0047

1998

Attachment
Sequence No. **12**

Your social security number
111 11 1111

Elizabeth N. Investwise

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

16	Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Next: Go to Part III on the back.	16	4,584
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Schedule D (Form 1040) 1998

Page **2**

Part III Summary of Parts I and II

17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 Next: Complete Form 1040 through line 39. Then, go to Part IV to figure your tax if: • Both lines 16 and 17 are gains, and • Form 1040, line 39, is more than zero.	17	4,584
18	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the smaller of these losses: • The loss on line 17; or • (\$3,000) or, if married filing separately, (\$1,500) Next: Complete Form 1040 through line 37. Then, complete the Capital Loss Carryover Worksheet on page D-6 if: • The loss on line 17 exceeds the loss on line 18, or • Form 1040, line 37, is a loss.	18	()

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39	19	5,764
20	Enter the smaller of line 16 or line 17 of Schedule D	20	4,584
54	Tax on taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40. ▶	54	636

1999 Workbook

Notes regarding Elizabeth's forms and schedules.

- Elizabeth's return is not impacted by her parents' income since she is **not under age 14**. Her AGI is **\$9,604** including a **\$4,584** net long-term capital gain. Her standard deduction is **\$3,840**, her earned income (wages) of \$3,590 plus \$250. Her taxable income is **\$5,764**, and her tax as computed in Part IV (partially shown) of Schedule D is **\$636**.
- Part IV, Schedule D computations:

Net long-term capital gain of \$4,584 × 10%	\$458
Tax Table tax on ordinary taxable income of \$1,180	178
Elizabeth's tax, line 54, Part IV, Schedule D	\$636

Now we will consider **Mary**, who has identical income to Elizabeth but is age 12. Page 1 of her Form 1040 (not shown) is identical to Elizabeth's. However, after line 39, the numbers differ. **Mary's tax of \$1,218 is almost twice as much as Elizabeth's tax of \$636.**

MARY'S 1998 FORM 1040 PAGE 2

Tax and Credits	34	Amount from line 33 (adjusted gross income)	34	9,604
	35a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here ▶ 35a		
Standard Deduction for Most People Single: \$4,250 Head of household: \$6,250 Married filing jointly or Qualifying widow(er): \$7,100 Married filing separately: \$3,550	b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 29 and check here ▶ 35b <input type="checkbox"/>		
	36	Enter the larger of your itemized deductions from Schedule A, line 28, OR standard deduction shown on the left. But see page 30 to find your standard deduction if you checked any box on line 35a or 35b or if someone can claim you as a dependent	36	3,840
	37	Subtract line 36 from line 34	37	5,764
	38	If line 34 is \$93,400 or less, multiply \$2,700 by the total number of exemptions claimed on line 6d. If line 34 is over \$93,400, see the worksheet on page 30 for the amount to enter	38	0
	39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	5,764
	40	Tax. See page 30. Check if any tax from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 . . . ▶	40	1,218
	41	Credit for child and dependent care expenses. Attach Form 2441	41	
	42	Credit for the elderly or the disabled. Attach Schedule R	42	
	43	Child tax credit (see page 31)	43	
	44	Education credits. Attach Form 8863	44	
45	Adoption credit. Attach Form 8839	45		
46	Foreign tax credit. Attach Form 1116 if required	46		
47	Other. Check if from a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify) _____	47		
48	Add lines 41 through 47. These are your total credits ▶	48		
49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0- ▶	49	1,218	

1999 Workbook

MARY'S 1998 FORM 8615, PART I

Form **8615**
Department of the Treasury
Internal Revenue Service (99)

Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,400

OMB No. 1545-0998
1998
Attachment
Sequence No. **33**

Child's name shown on return

▶ Attach ONLY to the child's Form 1040, Form 1040A, or Form 1040NR.

<p>Mary N. Investwise</p>		<p>Child's social security number 222 22 2222</p>
<p>A Parent's name (first, initial, and last). Caution: See instructions on back before completing. Ed Investwise</p>	<p>B Parent's social security number 333 33 3333</p>	
<p>C Parent's filing status (check one): <input type="checkbox"/> Single <input checked="" type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately <input type="checkbox"/> Head of household <input type="checkbox"/> Qualifying widow(er)</p>		

Part I Child's Net Investment Income

1	Enter the child's investment income, such as taxable interest and dividends. See instructions. If this amount is \$1,400 or less, stop ; do not file this form	1	6,014
2	If the child did not itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter \$1,400. If the child did itemize deductions, see instructions	2	1,400
3	Subtract line 2 from line 1. If the result is zero or less, stop ; do not complete the rest of this form but do attach it to the child's return	3	4,614
4	Enter the child's taxable income from Form 1040, line 39; Form 1040A, line 24; or Form 1040NR, line 38 ▶	4	5,764
5	Enter the smaller of line 3 or line 4 ▶	5	4,614

Note. Part I of Form 8615 is not complex. Line 1, \$6,014, is the total of Mary's interest income (\$35), dividends (\$1,395), and capital gains (\$4,584) from her Form 1040, Page 1 (not shown; see Elizabeth's Form 1040, page 1).

MARY'S 1998 FORM 8615, PARTS II AND III

Part II Tentative Tax Based on the Tax Rate of the Parent Listed on Line A

6	Enter the parent's taxable income from Form 1040, line 39; Form 1040A, line 24; Form 1040EZ, line 6; TeleFile Tax Record, line J; Form 1040NR, line 38; or Form 1040NR-EZ, line 14. If less than zero, enter -0-	6	201,315
7	Enter the total net investment income, if any, from Forms 8615, line 5, of all other children of the parent identified above. Do not include the amount from line 5 above	7	
8	Add lines 5, 6, and 7	8	205,929
9	Enter the tax on line 8 based on the parent's filing status. See instructions. If Schedule D or J (Form 1040) is used to figure the tax, check here ▶ <input checked="" type="checkbox"/>	9	54,833
10	Enter the parent's tax from Form 1040, line 40; Form 1040A, line 25; Form 1040EZ, line 10; TeleFile Tax Record, line J; Form 1040NR, line 39; or Form 1040NR-EZ, line 15. If any tax is from Form 4972 or 8814 , see instructions. If Schedule D or J (Form 1040) was used to figure the tax, check here ▶ <input checked="" type="checkbox"/>	10	53,735
11	Subtract line 10 from line 9 and enter the result. If line 7 is blank, enter on line 13 the amount from line 11 and go to Part III	11	1,098
12a	Add lines 5 and 7 12a		
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places)	12b	×
13	Multiply line 11 by line 12b ▶	13	1,098

Part III Child's Tax—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14	Subtract line 5 from line 4 14	1,150
15	Enter the tax on line 14 based on the child's filing status. See instructions. If Schedule D or J (Form 1040) is used to figure the tax, check here ▶ <input checked="" type="checkbox"/>	120
16	Add lines 13 and 15	1,218
17	Enter the tax on line 4 based on the child's filing status. See instructions. If Schedule D or J (Form 1040) is used to figure the tax, check here ▶ <input checked="" type="checkbox"/>	636
18	Enter the larger of line 16 or line 17 here and on Form 1040, line 40; Form 1040A, line 25; or Form 1040NR, line 39 ▶	1,218

Line 6 of Mary's Form 8615

This reports the parent's taxable income.

Line 7

Since no **other** children are under age 14, this line is blank.

Line 9

The method used to compute the tax liability on line 9 depends on whether there is any net capital gain included on line 8. If there is net capital gain on line 5, 6, or 7, then there is also net capital gain on line 8. Line 6, \$201,315, includes **\$14,793** of the parents' net capital gain. However, to compute the amount of net capital gain included on line 5, IRS Publication 929 provides **three** worksheets. (If line 7 also includes net capital gain, these worksheets must also be used to determine the amount of net capital gain included in line 7.) **Only one of the three worksheets will apply to an individual return.**



Use the following worksheet to figure the net capital gain included on line 5 of the child's Form 8615 if that line is the same as line 3 and line 2 is \$1,400.

Line 5 Worksheet #1

- A. Enter the child's net capital gain _____
- B. Enter the amount from line 1 of the child's Form 8615 _____
- C. Divide line A by line B (but do not enter more than 1) _____
- D. Multiply \$1,400 by the result on line C _____
- E. Subtract line D from line A. Enter the result here (but do not enter more than the amount on line 5 of Form 8615). This is the net capital gain included on line 5. _____



Use the following worksheet only if line 5 of the child's Form 8615 is the same as line 3 and line 2 is **more** than \$1,400.

Line 5 Worksheet #2

- A. Enter the child's net capital gain _____
- B. Enter the child's itemized deductions directly connected with the production of the child's net capital gain _____
- C. Subtract line B from line A _____
- D. Enter the amount from line 1 of the child's Form 8615 _____
- E. Divide line A by line D (but do not enter more than 1) _____
- F. Multiply \$700 by line E _____
- G. Subtract line F from line C. Enter the result here (but do not enter more than the amount on line 5 of Form 8615). This is the net capital gain included on line 5. _____



Use the following worksheet only if line 5 of the child's Form 8615 is less than line 3.

Line 5 Worksheet #3

- A. Enter the child's net capital gain _____
- B. If the child itemized deductions, enter the child's itemized deductions directly connected with the production of the child's net capital gain _____
- C. Subtract line B from line A _____
- D. If the child can claim his or her own exemption, enter \$2,700*. Otherwise, enter zero _____
- E. If the child itemized deductions, enter the child's itemized deductions *not* directly connected with the production of the child's net capital gain. Otherwise, enter the child's standard deduction _____
- F. Add lines D and E _____
- G. Enter the child's adjusted gross income (line 33 of the child's Form 1040) _____
- H. Divide line A by line G (but do not enter more than 1) _____
- I. Multiply line F by line H _____
- J. Subtract line I from line C. Enter the result here (but do not enter more than the amount on line 5 of Form 8615). This is the net capital gain included on line 5. _____

* If you enter more than \$124,500 on line G, see *Deduction for Exemptions Worksheet—Line 38* in the Form 1040 instructions for the amount to enter on line D.

1999 Workbook

The worksheets allocate the capital gain between that to be taxed at the parents' rate and that to be taxed at the child's rate. Based on the headings above each worksheet, **only Worksheet #1 applies to Mary's Form 8615.**

WORKSHEET #1 FOR MARY



Use the following worksheet to figure the net capital gain included on line 5 of the child's Form 8615 if that line is the same as line 3 and line 2 is \$1,400.

Line 5 Worksheet #1

A. Enter the child's net capital gain	<u>4,584</u>
B. Enter the amount from line 1 of the child's Form 8615	<u>6,014</u>
C. Divide line A by line B (but do not enter more than 1)	<u>.7622</u>
D. Multiply \$1,400 by the result on line C	<u>1,067</u>
E. Subtract line D from line A. Enter the result here (but do not enter more than the amount on line 5 of Form 8615). This is the net capital gain included on line 5 .	<u>3,517</u>

Since line 5, includes \$3,517 of net capital gain and line 6 contains \$14,793, the total of net capital gain included in the line 8 amount of \$205,929 on page 358 is \$18,310 ($\$3,517 + \$14,793 = \$18,310$).

Next, Part IV of a blank Schedule D must be completed as a worksheet to arrive at the amount of tax to be entered on line 9 of Mary's Form 8615 on page 358. When completing this worksheet, use information from the parents and all the parents' children for whom Form 8615 is filed, but **only** for those showing net capital gain. The instructions for completing the Schedule D worksheet are shown next. They are found in IRS Publication 929 *Tax Rules for Children and Dependents*.

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INSTRUCTIONS FROM PUBLICATION 929 FOR SCHEDULE D WORKSHEET FOR LINE 9 OF FORM 8615

Line 9 (tax on parent's taxable income plus children's net investment income). Figure the tax on line 9 in one of the following ways.

- If net capital gain is **not** included in the total on line 8, and line 8 is less than \$100,000, use the Tax Table to figure the tax on line 9. If line 8 is \$100,000 or more, use the Tax Rate Schedules.
- If net capital gain **is** included in the total on line 8, complete the Line 9 Schedule D Worksheet.
- If Schedule J (Form 1040) is used to figure the parent's tax, complete the Line 9 Schedule J Worksheet.

b) (Each other child's net capital gain from bottom line of line 5 worksheet ÷ That child's total net capital gain from line A of line 5 worksheet) × That child's line 25, Schedule D.

c) The parent's line 25, Schedule D.

- 8) Complete lines 26 through 54 of Schedule D (worksheet). Enter the amount from line 54 of Schedule D (worksheet) on line 9 of Form 8615 and check the box.

Do not attach this worksheet to the child's return.

Completing Line 9 Schedule D Worksheet. Use Part IV of **another** Schedule D as a worksheet to figure the tax to enter on line 9 of Form 8615. For purposes of this worksheet, use information from the parent and all the parent's children for whom Form 8615 is filed, but only for those showing net capital gain (excess of net long-term capital gain over net short-term capital loss). All Schedules D, Part IV, must be filled out before using this worksheet.

Complete this worksheet as follows:

- 1) On line 19 of Schedule D (worksheet), enter the amount from line 8 of Form 8615.
- 2) On line 20 of Schedule D (worksheet), enter the net capital gain included on line 8 of Form 8615.
- 3) Add the amounts from lines 21 of each Schedule D (actual). Enter the total on line 21 of Schedule D (worksheet).
- 4) On line 22 of Schedule D (worksheet), subtract line 21 from line 20.
- 5) Leave line 23 of Schedule D (worksheet) blank.
- 6) On line 24 of Schedule D (worksheet), add the following amounts:
 - a) (The child's net capital gain from bottom line of line 5 worksheet ÷ The child's total net capital gain from line A of line 5 worksheet) × The child's line 24, Schedule D (actual).
 - b) (Each other child's net capital gain from bottom line of line 5 worksheet ÷ That child's total net capital gain from line A of line 5 worksheet) × That child's line 24, Schedule D.
 - c) The parent's line 24, Schedule D.
- 7) On line 25 of Schedule D (worksheet), add the following amounts:
 - a) (The child's net capital gain from bottom line of line 5 worksheet ÷ The child's total net capital gain from line A of line 5 worksheet) × The child's line 25, Schedule D (actual).

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COMPLETED SCHEDULE D WORKSHEET FOR LINE 9 OF MARY'S FORM 8615

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39		205,929
20	Enter the smaller of line 16 or line 17 of Schedule D	20	18,310
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21	0
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	18,310
23	Combine lines 7 and 15. If zero or less, enter -0-	23	—
24	Enter the smaller of line 15 or line 23, but not less than zero	24	0
25	Enter your unrecaptured section 1250 gain, if any (see page D-7)	25	0
26	Add lines 24 and 25	26	0
27	Subtract line 26 from line 22. If zero or less, enter -0-	27	18,310
28	Subtract line 27 from line 19. If zero or less, enter -0-	28	187,619
29	Enter the smaller of: <ul style="list-style-type: none"> • The amount on line 19, or • \$25,350 if single; \$42,350 if married filing jointly or qualifying widow(er); \$21,175 if married filing separately; or \$33,950 if head of household 	29	42,350
30	Enter the smaller of line 28 or line 29	30	42,350
31	Subtract line 22 from line 19. If zero or less, enter -0-	31	187,619
32	Enter the larger of line 30 or line 31	32	187,619
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ▶	33	51,171
34	Enter the amount from line 29	34	42,350
35	Enter the amount from line 28	35	187,619
36	Subtract line 35 from line 34. If zero or less, enter -0-	36	0
37	Multiply line 36 by 10% (.10) ▶	37	0
38	Enter the smaller of line 19 or line 27	38	18,310
39	Enter the amount from line 36	39	0
40	Subtract line 39 from line 38	40	18,310
41	Multiply line 40 by 20% (.20) ▶	41	3,662
42	Enter the smaller of line 22 or line 25	42	0
43	Add lines 22 and 32	43	205,929
44	Enter the amount from line 19	44	205,929
45	Subtract line 44 from line 43. If zero or less, enter -0-	45	0
46	Subtract line 45 from line 42. If zero or less, enter -0-	46	0
47	Multiply line 46 by 25% (.25) ▶	47	0
48	Enter the amount from line 19	48	205,929
49	Add lines 32, 36, 40, and 46	49	205,929
50	Subtract line 49 from line 48	50	0
51	Multiply line 50 by 28% (.28) ▶	51	0
52	Add lines 33, 37, 41, 47, and 51.	52	54,833
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	53	57,762
54	Tax on taxable income (including capital gains). Enter the smaller of line 52 or line 53 here and on Form 1040, line 40. ▶	54	54,833

Note. The \$54,833 from line 54 is entered on line 9 of Mary's Form 8615 on page 358. The box for line 9 is marked X.

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Line 10 of Mary's Form 8615 (see page 358)

\$53,735 is taken directly from the parents' return (line 40, Form 1040, page 2 - see page 354).

The following information pertains to Mary's 1998 Form 8615, Parts II and III shown on page 358.

Line 11

\$1,098 is the result of subtracting line 10 from line 9. It is the tax on the portion of Mary's income taxed at her parents' rate.

Line 12 a & b

Since line 7 is blank, the line 11 amount of \$1,098 is entered in line 13.

Line 14

Line 14 shows the balance of Mary's taxable income of \$5,764 less \$4,614 that has been taxed at the parent's rate. That is \$1,150 (\$5,764 - \$4,614). Since Mary has net capital gains, a Schedule D, Part IV calculation is necessary to arrive at the figure to enter on line 15. However, as we previously did for line 5, we must compute the amount of net capital gain included in line 14. Using the same Worksheet #1 that was used before for line 5, the amount of Mary's capital gain that was taxed at the parents' tax rate (Worksheet #1, line E on page 360) is **subtracted** from Mary's net capital gain of \$4,584 (line 5 Worksheet #1, line A).

\$4,584	Line A of Worksheet #1 on page 360
<u>3,517</u>	Less: Line E of Worksheet #1 on page 360
\$1,067	Capital gain to be taxed at Mary's tax rate

Line 15

To calculate the tax at Mary's tax rate on the line 14 amount of \$1,150, another Schedule D, Part IV worksheet must be completed. This is necessary, as the line 14 amount of \$1,150 includes \$1,067 of net capital gain. See the instructions from Publication 929 and the completed Schedule D, Part IV worksheet, shown next.

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INSTRUCTIONS FROM PUBLICATION 929 FOR SCHEDULE D WORKSHEET FOR LINE 15 OF FORM 8615

Line 15 (tax on excess of child's taxable income over child's net investment income). Figure the tax on line 15 in one of the following ways, depending on whether there is any net capital gain included in the total on line 14.

No net capital gain on line 14. If net capital gain is *not* included in the total on line 14, and line 14 is less than \$100,000, use the Tax Table to figure the tax on line 15. If line 14 is \$100,000 or more, use the Tax Rate Schedules.

Net capital gain on line 14. If net capital gain *is* included in the total on line 14, you must determine the amount of the net capital gain included on line 14 to compute the tax on line 15. Figure that amount by using the *Line 5 Worksheet* used to figure net capital gain included on line 5. Subtract the net capital gain included on line 5 (the amount on the last line of the worksheet) from the child's net capital gain (the amount on line A of that worksheet). The result is the amount of net capital gain included on line 14 of the child's Form 8615.

Once you have determined the amount of net capital gain on line 14, use Part IV of **another** Schedule D as a worksheet to figure the tax to enter on line 15 of Form 8615.

Complete this worksheet as follows:

- 1) On line 19 of Schedule D (worksheet), enter the amount from line 14 of Form 8615.
- 2) Leave line 20 of Schedule D (worksheet) blank.
- 3) Leave line 21 of Schedule D (worksheet) blank.
- 4) On line 22 of Schedule D (worksheet), enter the net capital gain included on line 14 of Form 8615.
- 5) Leave line 23 of Schedule D (worksheet) blank.
- 6) Subtract the amount figured in step 6a) under *Completing Line 9 Schedule D Worksheet* from the amount on the child's line 24, Schedule D (actual). Enter the result on line 24 of Schedule D (worksheet).
- 7) Subtract the amount figured in step 7a) under *Completing Line 9 Schedule D Worksheet* from the amount on the child's line 25, Schedule D (actual). Enter the result on line 25 of Schedule D (worksheet).
- 8) Complete lines 26 through 54 of Schedule D (worksheet). Enter the amount from line 54 of Schedule D (worksheet) on line 15 of Form 8615 and check the box.

Do not attach this worksheet to the child's return.

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SUMMARY

A. Elizabeth, age 16

Since Elizabeth is 14 or older, the unearned income issues of a child under the age of 14 do not apply. As a result, **all of her unearned income is taxed at her rates.**

Taxable income	\$5,764
Net capital gains	$\$4,584 \times 10\% = \458
Remaining taxable income	$\$1,180 \times 15\% = \underline{178^*}$
Elizabeth's tax	\$636

*From tax table.

See page 357 for relevant notes concerning Elizabeth's tax of \$636.

B. Mary, age 12

Mary's unearned income in excess of \$1,400 is taxed at her parents' rates.

Taxable income	\$5,764
Amount of Mary's investment income taxed at her parents' rates	<u>-4,614</u>
Amount of Mary's investment income taxed at Mary's rate	1,150

Mary's Tax Computation

Taxed at parents' rate	
\$ 4,614	Total
<u>(3,517)</u>	Capital gains $\times 20\% =$
\$ 1,097	Ordinary income $\times 36\% =$
	<u>395</u>
Line 13, Form 8615 on page 358	1,098

Taxed at Mary's rate	
\$ 1,150	Total
<u>(1,067)</u>	Capital gains $\times 10\% =$
\$ 83	Ordinary income $\times 15\% =$
	<u>13*</u>
Line 15, Form 8615 on page 358	\$ 120

Mary's tax-line 18, Form 8615 on page 358	1,218
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*From tax table.

PROBLEM 8: TAXPAYER PENALTIES

BACKGROUND

The number of individual taxpayer penalties that the IRS 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 focuses on the most common ones and the procedures to appeal them.

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Note. The IRS Restructuring and Reform Act of 1998 shifted the **burden of proof in court proceedings** to the IRS with respect to the liability of any **individual taxpayer** for IRS assessed penalties. This applies to IRS examinations **started after July 22, 1998**.

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 based 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 that may be claimed on the return. Timely payments include:

- Withholding credits
- Estimated tax payments
- Tax deposits (Example: those made with extension requests)
- Overpayments from prior periods
- 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%.

Note. The FTF penalty ends after the first five months, but the FTP penalty continues until the amount owed the IRS is paid. In most situations where both penalties apply at the same time, the **maximum** FTF penalty will be 22.5%.

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 the **smaller** of:

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

Note. In one Tax Court case, the IRS tried 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)]. The IRS lost this case. Subsequently, the IRS acquiesced and has agreed to follow the decision reached by the Tax Court.

Reasonable Cause Exception. The FTF 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 (if already assessed). This reasonable cause issue 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 failure to file penalty:

1. Numerous (over 500) court cases and several Revenue Rulings
2. IRS Regulations [see Treas. Reg. §301.6651-1(c)]

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3. *Internal Revenue Manual—Penalty Handbook (IRM-PH)* [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.

- **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. (*IRM-PH*).
- **Circumstances beyond the taxpayer's control.** (*IRM-PH*).
- **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-PH*).
- **Advice of a tax professional** (*IRM-PH*, numerous court cases).
- **Death, serious illness, or unavoidable absence of taxpayer or taxpayer's immediate family** (*IRM-PH*). However, in four court cases, the illness or death of the taxpayer's accountant did **not** constitute reasonable cause.
- **Inability to obtain records** (*IRM-PH*).
- **Erroneous oral advice from an IRS employee** (*IRM-PH*).
- **Fire, casualty, natural disaster, or other disturbance** (*IRM-PH*).

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 file penalty with 15% substituted for 5%.

According to the manual used by IRS examiners, the following factors should be considered when developing a FFTF penalty issue:

- The taxpayer refuses or is unable to explain the failure to file.
- The taxpayer's testimony does not meet or agree with the facts of the case.
- There is a **history** of failing to file or late filing, but an apparent ability to pay.
- The taxpayer fails to reveal or tries to hide assets.
- 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.
- In addition to the above, the taxpayer is **aware** of the filing requirement.

Example. A tax attorney failed to file income tax returns for the years 1992 through 1997. He had sufficient funds to pay his federal income tax obligation. After initial contact by an IRS revenue agent, the attorney gave his delinquent 1992–1997 returns to the agent. The agent accepted the delinquent returns and forwarded them to the IRS service center for processing. A subsequent exam of the 1995 return disclosed a substantial understatement of Schedule C gross receipts.

It is possible that the agent could assess the 75% fraudulent failure to file penalty (FFTF) on the six delinquent returns received from the attorney. In addition, the agent could assess the 75% traditional fraud penalty on the underpayment of tax (the deficiency) for the 1995 return.

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 enforcement personnel 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 assessed. If reasonable cause exists, the examiner will advise nonassessment of the penalty.

Practitioner Caution. If you and your tax client are dealing with the IRS, you should explore the possibility of reasonable cause to prevent the assessment 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% (.005) of the unpaid tax for the first month the penalty applies, and an additional one-half of 1% for each additional month or fraction of a 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 FTF 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. 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** condition below is applicable:

- **For tax years beginning after 1997**, the total tax shown on an individual tax return less the amount paid through withholding is **less than \$1,000**. (**Note.** For tax years beginning **before 1998**, the threshold was \$500.)
- 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 1999 Estimated Tax Payments. Estimated tax payments must be made if an individual taxpayer expects to owe at least \$1,000 in tax for 1999, after subtracting withholding and credits, and the withholding and credits amount is **less** than the **smaller** of:

- 90% of the tax shown on the **1999** tax return, or
- 100% of the tax shown on the **1998** tax return (the 1998 return must cover 12 months)

Note. There is an exception for farmers and fishermen.

Estimated Tax Safe Harbor for High Income Individuals. For 1999 estimated tax installments, the estimated tax **safe harbor** for high income individuals (other than farmers and fishermen) has been mod-

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ified. If the taxpayer's **1999** adjusted gross income is **more than \$150,000** (\$75,000 if married filing a separate return), the penalty does not apply if **1999** estimated tax payments are **at least the lesser of:**

- 90% of the taxpayer's **1999** tax liability, or
- 105% of the total tax shown on the **1998** return covering all 12 months.

Note. If a taxpayer's 2000 (or 2001) adjusted gross income is more than \$150,000 (\$75,000 if married filing a separate return), 2000 (or 2001) estimated tax payments may be based on **106% of the preceding tax year's tax liability** in order to avoid the penalty.

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

- Federal income tax is withheld from the taxpayer's wages, pensions, annuities, gambling winnings, or other income, or
- 1998 (or a later year's) estimated tax payments would be required to avoid the penalty **even if no household employment taxes were owed.**

Practitioner Caution. If any of your clients begin to employ household employees in 1999, either 1999 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 1999 estimated tax penalty.

Note. Household employment taxes are included on line 12 (Other taxes) on the 1999 Estimated Tax Worksheet found in the 1999 Form 1040-ES package. They are computed on the 1999 Schedule H, which will be attached to the 1999 Form 1040.

Reasonable Cause Exception to 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 three following circumstances:

- 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)].
- 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)].
- An underpayment of any installment due **before August 22, 1998**, was due to **changes made by the IRS Restructuring and Reform Act of 1998.**

Note. To apply for one of these three waivers, an explanation should be attached to Form 2210 complete with any documentation. See Chapter 4 of IRS Publication 505, *Tax Withholding and Estimated Tax*, for specific information on the preparation of Form 2210 in this situation.

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 and your client’s time to use it to minimize or eliminate the penalty.

The explanation and example contained in IRS Publication 505 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. 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 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 expenses	\$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, Schedule F.
4. Fertilizer	\$3,600 increase in income	Eli made a math error in his farm record book for the eight separate fertilizer entries. The eight entries in 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 item 2 above

Revenue Agent’s Conclusion. In the opinion of the revenue agent, only adjustments 1 (\$46,700 in omitted grain sales) and 3 (\$3,200 in overstated storage expenses) were due to Eli’s negligence. Adjustments 2, 4, and 5 were deemed to be technical and nonnegligent errors.

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 3 only**. The computerized exam report should clearly show this computation. The computation of the 20% negligence penalty should show that adjustments 1 and 3 only 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—

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- 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 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) under 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, and the taxpayer acted in good faith” [I.R.C. §6664(c)(1) and Treas. Reg. §1.6664-4(a)]. See the discussion of 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 107–11 in the 1995 *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:**

- 10% of the tax required to be shown on the return (the corrected tax), or
- \$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 1997 Form 1040 was examined by the IRS. She reported a total tax liability of \$8,300. The IRS examiner proposed numerous adjustments. The 1997 exam report disclosed a corrected total tax liability of \$14,500. **Brenda’s understatement of income tax for 1997 is \$6,200.** Computation of the greater of 10% of the corrected tax or \$5,000:

- 10% of the corrected tax: $10\% \times \$14,500 = \$1,450$, or
- **\$5,000**

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The **greater** amount is \$5,000. Since Brenda's 1996 understatement of her 1997 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 1997 exam report will be \$1,240 ($20\% \times \$6,200$).

Exceptions to the 20% Accuracy-Related Penalty for Substantial Understatement of Tax. There are **three** exceptions to the penalty. Any 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 that is due to **substantial authority**. See the What's New chapter for a thorough discussion of what constitutes substantial authority.

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 of 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.

Note. Some IRS examiners are unaware that the reasonable cause and good faith exception applies to negate a substantial-understatement-of-tax penalty exam proposal.

7. PROCEDURES FOR REQUESTING PENALTY RELIEF

Enactment of the IRS Restructuring and Reform Act of 1998 may cause IRS enforcement and service center employees to 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 [IRM-PH§(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 [IRM-PH §(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 the IRS determination regarding a penalty, they have the right to an administrative appeal.

Editorial Notes

1. In most situations, the pre-assessment appeal is 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 the following note).
2. According to §(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:
 - *Internal Revenue Manual (IRM) §(11)00*
 - Text 600 of *IRM 8114, Appeals Returns Processing and Control Handbook*

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 a **“pre-assessment appeal.”**)
- 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 **“post assessment 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**. This request is made on Form 843, Claim for Refund and Request for Abatement.

8. IMPORTANT PENALTY PROVISIONS OF THE IRS RESTRUCTURING AND REFORM ACT OF 1998

- The IRS must 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 [I.R.C. §6751(c)].
- 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) [I.R.C. §6751(b)(1)].
- Effective date of these new provisions: They apply to notices issued and penalties assessed after **December 31, 2000**.

9. PENALTY RELIEF—APPLICATION CHART (*IRM—PH*)

I.R.C. 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(c)(1)	Failure to File Annual Return by Exempt Organization	Yes	Yes
6652(c)(2)	Failure to File Returns under I.R.C. §6034 or 6043(b)	Yes	Yes
6652(d)(2)	Notification of Change in Status of a Plan	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
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
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

PROBLEM 9: EXEMPTION DEDUCTION AND EARNED INCOME CREDIT ISSUES

GENERAL INFORMATION

Taxpayers with children and other dependents face a host of tax issues other than the possible dependency exemption deduction of \$2,750 for 1999. They include, but are not limited to:

- Education credits on Form 8863 (see Problem 10 in this chapter)
- Child tax credit (Worksheets in Form 1040 instructions)
- Earned income credit (Schedule EIC)
- Child and dependent care credit (Form 2441)
- Special dependent exemption deduction rules for divorced or separated individuals [includes Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents) signed by the custodial parent]
- Tax for children under 14 who have investment income of more than \$1,400 in 1999 (Form 8615—commonly called the “kiddie tax” form—see Problem 7 in this chapter)
- Parents’ election to report child’s interest and dividend income (Form 8814—see Problem 7 in this chapter)
- Special AMT exemption amount for a child under 14 (line 22, Form 6251, and the Exemption Worksheet for line 22 in the instructions for Form 6251)

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- Potential creation of parental AMT liability by claiming children's dependency exemptions for regular tax (see the discussion of the *Klaassen* Appeals Court case in the What's New chapter and pages 81-85)
- Qualification for the Head of household or Qualifying widow or widower filing status
- Unmarried couples who cohabit (earned income credit complications)
- Phase-out of personal exemption deductions for high-AGI taxpayers (worksheet in the Form 1040 instructions; see chart below for the increased 1999 phase-out floors)

Filing Status	Phase-out Begins at:
Joint or Surviving Spouse	\$189,950
Head of Household	158,300
Single	126,600
Married Separate	94,975

A question-and-answer format is used in this chapter to address some of these troublesome dependency-related issues.

Question 1 Facts. Mary has custody of her two young sons (ages 6 and 8) in 1999. She allows her ex-husband to claim the exemption deductions for the two sons by signing Form 8332, even though he paid only \$4,000 in child support. Her \$8,000 of wages in 1999 is her total 1999 income. She and her two sons lived **for the last 10 months of 1999** with her partner, John, who is the father of their new child, born in December 1999. His 1999 AGI is \$300,000. John furnished chief support during the last 10 months of 1999 for everyone living with him in his expensive home. He is **entitled** to claim the exemption deduction for their new child on his single 1999 return, but the \$2,750 exemption **deduction** is **lost** due his high AGI.

Question 1. *Can Mary claim earned income credit (EIC) based on two qualifying children (the two sons by her previous marriage) on her 1999 single return?*

Answer 1. Yes. She does not have to own the home where her two sons reside. **A qualifying child for EIC purposes must meet three tests:** (1) relationship, (2) residency, and (3) age. An unmarried child does **not** have to be a dependent of the taxpayer who claims the EIC. Mary meets all three tests for 1999. Therefore, she is entitled to claim EIC for her two sons on her 1999 single return. Her 1999 earned income credit will be \$3,210.

Notes

1. If a child is a qualifying child for more than one taxpayer, then **only the taxpayer with the higher AGI is eligible for EIC with respect to that child** [I.R.C. §32(c) (1)(C)]. If the two young sons had lived with the mother's domestic partner for the **entire 1999 tax year**, the two children would have been his qualifying children for EIC purposes. This is due to the liberal **foster child** provisions of I.R.C. §32.
2. The ex-husband is **probably not** entitled to the exemption deductions for his two sons for 1999. Form 8332 (Release of Claim to Exemptions for Child of Divorced or Separated Parents) is valid **only if the parents between them furnish more than half of the children's support**. Since the John apparently provided more than half of the support for her two young sons in 1999, he is the only one who meets the support test. However, he does not meet the **member of household or relationship test**, as the two children did **not** reside with him all of 1999. Even if he did, his exemption deduction amount of \$5,500 is lost due to his high AGI. But **if Mary married John in 1999**, Form 8332 would regain its validity since support provided by a spouse (step parent) is considered to be provided by the other spouse (Mary in this case).

Practitioner Caution. There is no provision in the law to revoke a Form 8332 waiving the exemptions for all future years. The courts have held that contract law applies. Therefore, the waiver is irrevocable. To ensure continued payment of child support, custodial parent clients should be advised to complete Form 8332 on a year-by-year basis.

Question 2 Facts. An unmarried couple cohabits, and they have two children. All four live in a rented home in 1999. They file their individual 1999 returns and each claims two exemption deductions—a personal exemption deduction and a dependent exemption deduction for a child. They **each** had wages of approximately \$30,000 in 1999.

Question 2. *Do each of them have to file as single in 1999, or can one of them file as head of household?*

Answer 2. One of the parents will qualify for head-of-household filing status, but the other will not. To qualify for head of household, an **unmarried person** must pay **more than half the cost of maintaining a home** that was:

- His or her **principal home** for more than half the year, and
- The **principal place of abode** for a child or any other relative eligible to be claimed as a dependent.

An unmarried child of the taxpayer **does not have to be a dependent** in order for the parent to qualify for head of household. However, a married child does.

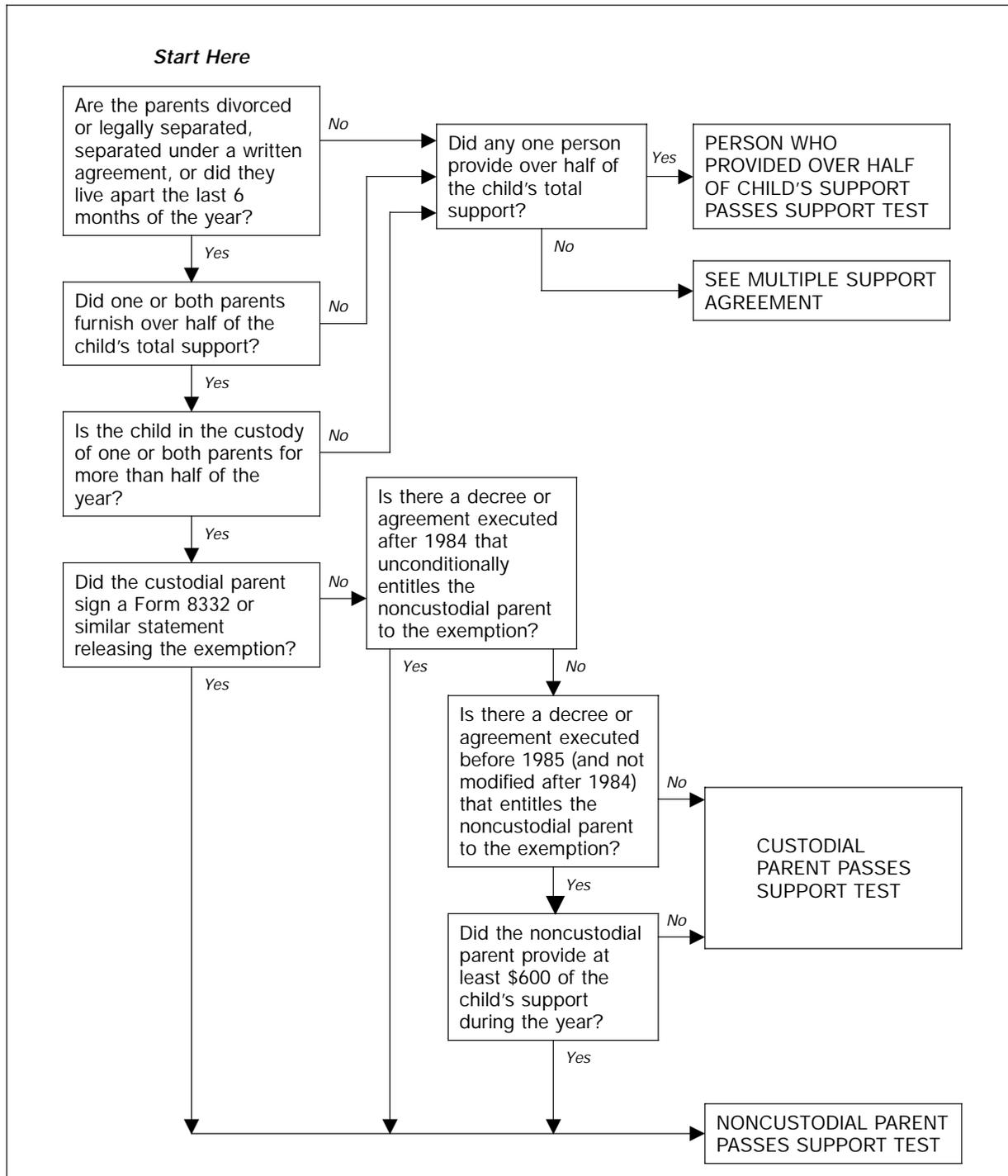
Since the parents and their two children resided all of 1999 in the same house, **only one** will be able to meet the requirement of paying more than half the cost of maintaining the home. That parent will **probably** be the one with the greater amount of take-home pay in 1999.

Question 3 Facts. A married couple separates on June 1, 1999. Before the separation, they lived together in the same home with their 5-year-old son. The mother had custody of the child from the date of separation through September 1999. The father then took custody of the child for the rest of the year.

Question 3. *Who is considered the custodial parent for 1999?*

Answer 3. The mother qualifies as the custodial parent since she had custody for four of the seven months following the separation. If she does not sign Form 8332, the father **cannot** claim the dependency exemption in 1999. See the following flow chart from IRS Publication 504, *Divorced or Separated Individuals*.

Figure 1. Support Test for Children of Divorced or Separated Parents



Question 4. *What are the advantages of filing Form 8814 (Parents' Election to Report Child's Interest and Dividends) as an alternative to filing Form 8615 (Tax for Children Under Age 14 Who Have Investment Income of More than \$1,400)?*

Answer 4. The principal advantage of using Form 8814 is the **time and expense savings involved in preparing the child's return.** Another potential but uncommonly used advantage is to provide for a larger deduction for charitable contributions limited by AGI (see Problem 2 in this chapter). In addi-

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tion, parents who have otherwise unusable losses or credits may benefit from including the child's income. Finally, an estimated tax penalty for a child may be avoided.

The **disadvantages** of using Form 8814 on the parents' return are many and include:

- The probability of increasing state income tax liability
- Limiting IRA contribution deductions due to the AGI phase-out rules
- Increasing the potential for application of the exemption phase-out rules for high-income taxpayers
- Increasing the potential for the application of the 3% of AGI phase-out of itemized deductions of high-income taxpayers
- An increase in the 7.5% AGI limitation on medical expenses
- Increasing the potential for limiting the special \$25,000 rental real estate loss allowance in Part II of Form 8582 (Passive Activity Loss Limitations)
- Child's investment income possibly taxed at a higher rate on the parent's return than on the child's own return (see Problem 7 in this chapter)
- Losing the deduction (if any) for the penalty on early withdrawal of a child's savings (line 30, Form 1040)

Question 5 Facts. Patti Ogden was married to John Ogden. He died in June 1999. Patti remarried Anthony McFail in December 1999. Patti's **only income** in 1999 was a nontaxable personal injury settlement of \$8,750. John Ogden's 1999 income consisted of \$23,000 of wages. Anthony McFail's 1999 gross income was \$26,500.

Question 5A. *If Patti and Anthony file a joint 1999 return, can Patti's \$2,750 exemption deduction be claimed on the final 1999 return of the decedent, John Ogden?*

Answer 5A. No. In that case, John Ogden's final 1999 return must use the **married filing separate** filing status, and no exemption is allowed for Patti.

Question 5B. *If Patti and Anthony do not file jointly for 1999, may Patti's \$2,750 exemption deduction be claimed on Anthony's separate 1999 return?*

Answer 5B. Yes, since Patti had no gross income in 1999. In addition, Patti's \$2,750 exemption deduction may be claimed on John's final 1999 separate return (Rev. Rul. 71-159).

Note. If Patti had even \$1 of gross income in 1999, Patti's exemption deduction could **not** be claimed on **either** Anthony's **or** John's 1999 separate return. If that was the case, Anthony could claim Patti's exemption deduction **only** by filing a joint 1999 return with her.

PROBLEM 10: EDUCATION CREDITS

EXAMPLE 1

Facts. Scott Turner began his **graduate studies** at Midwestern University in the spring semester of the 1997-98 academic year. Scott has been financing his tuition costs at Midwestern **via student loans in his own name** (Stafford loans). His mother, Beth Turner, has provided the rest of his support (lodging, food, transportation, entertainment, medical, and other support items) for the calendar year 1998.

Scott was 23 in 1998, and his income was only \$700 of interest and dividends. Beth's modified 1998 AGI was \$38,000. She is single and qualified as head of household for 1998.

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Scott received the following documents from Midwestern University:

- 1998 Form 1098-T
- Informational letter from the Financial Aid Office (not shown)
- Statement of Account for the period 7-1-98 through 12-31-98

CORRECTED (if checked)

FILER'S name, street address, city, state, ZIP code, and telephone number		1	OMB No. 1545-1574	Tuition Payments Statement
Midwestern University		2	1998 Form 1098-T	
FILER'S Federal identification no. 36 33 3333	STUDENT'S social security number 111 11 1111			Copy B For Student This is important tax information and is being furnished to the Internal Revenue Service.
STUDENT'S name Scott Turner				
Street address (including apt. no.) City, state, and ZIP code				
Account number (optional)	3 At least half-time student (if checked) <input checked="" type="checkbox"/>	4 Graduate student (if checked) <input checked="" type="checkbox"/>		

Form **1098-T**

(Keep for your records.)

Department of the Treasury - Internal Revenue Service

Midwestern University Statement of Account

The following is an itemization of all transactions posted to your account at Midwestern University between 7/1/98 and 12/31/98.

<i>Student:</i>	Scott Turner	<i>Social Security Number:</i>	111-11-1111
<i>Program of Study:</i>	Psychology	<i>Class Level:</i>	G2
<i>Campus:</i>	IL		
Charges			
8/11/98	Tuition Charge		\$4,037.00
10/23/98	Tuition Charge		\$4,037.00
		TOTAL:	\$8,074.00
Payment/Credit			
8/28/98	Stafford Loan		(\$2,400.00)
8/28/98	Stafford Loan		(\$2,040.00)
11/20/98	Stafford Loan		(\$2,400.00)
11/20/98	Stafford Loan		(\$2,040.00)
		TOTAL:	(\$8,880.00)
Refunds			
7/3/98	Living Expense Refund		\$123.00
9/2/98	Living Expense Refund		\$403.00
11/25/98	Living Expense Refund		\$403.00
		TOTAL:	\$929.00

PLEASE RETAIN THIS STATEMENT FOR TAX REPORTING PURPOSES

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Assume that Beth is **entitled to claim Scott's exemption deduction** on her 1998 return as the support she provided **exceeded** his \$8,074 payment of tuition via his student loans during 1998.

Question 1A. *Is Beth able to claim the Lifetime Learning Credit on her 1998 Form 1040 (single filing status)?*

Answer 1A. Yes. Beth's modified 1998 AGI of \$38,000 is **below** the phase-out floor of \$40,000.

Question 1B. *Is the \$8,074 of tuition deemed to have been paid by Beth for purposes of computing the Lifetime Learning Credit on her 1998 Form 8863?*

Answer 1B. Yes. Qualified tuition and related expenses paid by a student are treated as paid by a taxpayer if the student is a claimed dependent of the taxpayer for the taxable year in which the expenses are paid [Prop. Reg. §1.25A-5(b)].

See Beth's completed 1998 Form 8863.

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Form **8863**
Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions on pages 3 and 4. ▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

1998

Attachment
Sequence No. **51**

Name(s) shown on return

Beth Turner

Your social security number

Part I Hope Credit

1	(a) Name of student First, Last	(b) Student's social security number	(c) Qualified expenses (but do not enter more than \$2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
				
				
				
2	Add the amounts in columns (d) and (f)			2		
3	Add the amounts on line 2, columns (d) and (f) ▶					3

Part II Lifetime Learning Credit

4	(a) Name of student	(b) Student's social security number	(c) Qualified expenses (after June 30, 1998). See instructions
	First Last		
	Scott Turner	111 11 1111	8,074 00
		
		
5	Add the amounts on line 4, column (c) and enter the total		5 8,074 00
6	Enter the smaller of line 5 or \$5,000		6 5,000 00
7	Multiply line 6 by 20% (.20) ▶		7 1,000 00

Part III Allowable Education Credits

8	Add lines 3 and 7.		8 1,000 00
9	Enter: \$100,000 if married filing jointly; \$50,000 if single, head of household, or qualifying widow(er)	9	50,000 00
10	Enter the amount from Form 1040, line 34 (or Form 1040A, line 19)*	10	38,000 00
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop ; you cannot take any education credits	11	12,000 00
12	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	12	10,000 00
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)	13	× .
14	Multiply line 8 by line 13 ▶	14	1,000 00
15	Enter your tax from Form 1040, line 40 (or Form 1040A, line 25)	15	3,936 00
16	Enter the total, if any, of your credits from Form 1040, lines 41 and 42 (or from Form 1040A, lines 26 and 27)	16	0
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop ; you cannot take any education credits	17	3,936 00
18	Education credits. Enter the smaller of line 14 or line 17 here and on Form 1040, line 44 (or Form 1040A, line 29) ▶	18	1,000 00

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

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EXAMPLE 2

Facts. Assume the same facts as in Example 1 except:

- Scott Turner's 1998 modified AGI was \$12,000, which consisted mainly of wages.
- Beth Turner's 1998 modified AGI was \$65,000. She still met the support test.

Question 2A. *If Beth claims Scott as her dependent on her 1998 Form 1040, will she be entitled to the \$1,000 Lifetime Learning Credit for Scott?*

Answer 2A. No, because she is single and her modified AGI of \$65,000 **exceeds** the phase-out ceiling (the phase-out begins at \$40,000 of modified AGI and is fully effective at \$50,000).

Question 2B. *Even though Beth is entitled to claim Scott's exemption deduction, may she choose not to do so?*

Answer 2B. Yes. According to proposed regulations issued by the IRS in January 1999, Beth may decide to forgo Scott's exemption deduction on her 1998 Form 1040 [Prop. Reg. §1.25A-1(g)].

Question 2C. *If Beth decides not to claim Scott's exemption deduction on her 1998 Form 1040, what are the results?*

Answer 2C. Scott will not be entitled to claim his own exemption deduction, but he will be eligible to claim the nonrefundable \$1,000 Lifetime Learning Credit on his 1998 tax return.

Question 2D. *What should Beth do?*

Answer 2D. She should get out her calculator or software to see which way saves the most tax.

Calculations

A. If Beth does **not** claim Scott's exemption, her total 1998 tax is calculated as follows:

Beth's 1998 AGI	\$65,000	
Beth's itemized deductions	(8,000)	
Beth's exemption deduction	(2,700)	
	<hr/>	
Beth's 1998 taxable income	\$54,300	
Beth's 1998 tax from Tax Table	\$10,798	(Head of household)

Scott's 1998 tax is calculated as follows:

Scott's 1998 AGI	\$ 12,000
Scott's standard deduction	(4,250)
	<hr/>
Scott's 1998 taxable income	\$ 7,750
Scott's tax before credits	1,166
Less: Lifetime Learning Credit	(1,000)
Scott's 1998 tax after credits	\$ 166

Total 1998 tax liability of Beth and Scott if Beth decides **not** to claim Scott's exemption on her 1998 return:

Beth's total 1998 tax	\$10,798
Scott's total 1998 tax	166
	<hr/>
Total	\$10,964

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B. If Beth **does** claim Scott's exemption, her total 1998 tax is calculated as follows:

Beth's 1998 AGI	\$65,000	
Beth's itemized deductions	(8,000)	
Beth's and Scott's exemption deductions	(5,400)	
	<hr/>	
Beth's 1998 taxable income	\$51,600	
Beth's 1998 tax from Tax Table	\$10,042	(head of household)

Note. Beth is not eligible for the Lifetime Learning Credit due to the AGI phase-out rule.

Scott's 1998 tax is calculated as follows:

Scott's 1998 AGI	\$ 12,000
	0
Scott's standard deduction	(4,250)
	<hr/>
Scott's 1998 taxable income	\$ 7,750
Scott's 1998 tax from Tax Table	\$ 1,166

Total 1998 tax liability of Beth and Scott if Beth decides to claim Scott's exemption on her 1998 return:

Beth's total 1998 tax	\$10,042
Scott's total 1998 tax	1,166
	<hr/>
Total	\$11,208

Conclusion. Beth and Scott will save **\$244** if Beth **does not** claim Scott's exemption on her 1998 return.

Question 2E. *Are there any **general guidelines** to help determine when parents should forgo the dependency exemption for a child to maximize tax savings?*

Answer 2E. For 1999 tax returns, the following guidelines can be used. The assumptions are that:

- The parents of the student file a joint 1999 tax return.
 - The child is a college freshman.
 - The tuition paid in 1999 is more than \$2,000.
 - The child's 1999 taxable income is subject to the lowest (15%) tax rate.
- If the parents' 1999 AGI is under \$80,000, claim the exemption deduction. **Result:** The parents will be able to deduct the full exemption deduction of \$2,750 and the entire Hope credit of \$1,500.
 - If the parents' 1999 AGI exceeds \$312,450, do not claim the exemption deduction. **Reason:** The parents lose the \$2,750 exemption deduction because of the AGI phase-out, and they don't qualify for the \$1,500 Hope credit. If they don't claim the exemption deduction, the child may be able to at least partially take advantage of the \$1,500 Hope credit to reduce the child's tax to zero.
 - If the parents' 1999 AGI is between \$80,000 and \$312,450, use the calculator or software to reach a conclusion. The bottom line in this scenario is to calculate whether the Hope credit provides a larger benefit to the child than the credit and exemption deduction provide to the parents.

The parents can have a **partial** Hope credit with AGI between \$80,000 and \$100,000. Between \$100,000 and \$189,950, they get **full benefit** of the exemption deduction for **regular** tax purposes (but not for AMT). The exemption deduction is phased out for regular tax purposes between \$189,950 and \$312,450.

PROBLEM 11: FINANCIAL DISTRESS—BANKRUPTCY

When a debtor repays the principal of a loan, there are no income tax consequences because the debtor is simply returning money that he or she received without recognizing it as income. Payment of the loan does not change the debtor's wealth since the decrease in liabilities is matched by a decrease in wealth.

However, if debts are discharged without payment from the debtor, the debtor's wealth increases because his or her liabilities are decreased but his or her assets are not. That increase in wealth is income to the debtor [I.R.C. §61(a)(12)] unless it is excluded from income under one of the exceptions of I.R.C. §108.

The bankruptcy exception under I.R.C. §108(a)(1)(A) is discussed in this problem. The insolvency and qualified farm indebtedness exceptions are discussed in the Agricultural Issues chapter.

DEBTS DISCHARGED IN BANKRUPTCY

Debts that are discharged while a taxpayer is in bankruptcy under Title 11 of the U. S. Code are not income. Title 11 includes all of the bankruptcy options such as Chapter 7 (Liquidation), Chapter 11 (Reorganization of a Business), Chapter 12 (Farmers) and Chapter 13 (Wage Earners). The discharge of debt occurs 90 days after the filing of a Chapter 7 bankruptcy, at the time of confirmation of a Chapter 11 plan, and at the time of completion of a Chapter 12 or 13 plan.

ATTRIBUTE REDUCTION

The debtor's tax attributes must be reduced by the amount of discharged debt that is excluded from income under the bankruptcy exception [I.R.C. §108(b)(1)]. If the debtor is an individual filing for bankruptcy under Title 11 of the U.S. Code, **the required reduction of tax attributes must be made to the attributes acquired from the debtor taxpayer by the bankruptcy estate, a separate taxable entity resulting from the filing of the case.** (Chapters 12 and 13 do not create a separate entity.) Also, the choice of whether to first reduce the basis of depreciable property before reducing other tax attributes must be made by the trustee of the bankruptcy estate (but not in a Chapter 12 or 13 bankruptcy).

Order of Attribute Reduction. The tax attributes are reduced in the following order:

- **NOL.** Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year [current-year loss is used first—§108(b)(4)(B)].
- **General business credit.** Any carryover to or from the taxable year of the discharge of an amount allowable under
 1. §38 (general business credit),
 2. §40 (relating to expenses of work incentive programs),
 3. §44B (relating to credit for employment of certain new employees), or
 4. §44E (relating to alcohol used as fuel).

These credits are reduced 33 1/3% for each \$1 of discharged indebtedness.

- **Minimum tax credit.** Any minimum tax credit available under I.R.C. §53(b) as of the beginning of the tax year **immediately following** the taxable year of the discharge.
- **Capital loss carryovers.** Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year (current year used first).
- **Basis reduction of taxpayer's property.** The basis reduction must conform to the requirements of I.R.C. §1017. It is made to the taxpayer's property, and the following rules are applicable:

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1. **No reduction** is made to the basis of property that the debtor treats as **exempt property** [§1017(c)(1)].
2. The reduction in basis **is not treated** as a disposition for investment credit recapture purposes [§1017(c)(2)].
3. **The reduction in basis cannot exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge** [but this general rule does not apply to reductions in basis under I.R.C. §108(b)(5)—Special election].
4. Reduction in basis applies to any property of the taxpayer held **at the beginning** of the tax year following the year of discharge.
5. **Any reduction in basis is treated as a depreciation deduction.** On a later sale of the property at a gain, §1245 recapture (ordinary income treatment) will apply **even though the property that has a basis reduction is not §1245 or §1250 property** [I.R.C. §1017(d)(1)(A)].
6. Treas. Reg. §1.1017-1 prescribes the sequence of basis reduction:
 - a. Real property used in a trade or business or held for investment, other than real property described in §1221(1), that secured the discharged indebtedness immediately before the discharge;
 - b. Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge;
 - c. Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in §1221(1);
 - d. Inventory, accounts receivable, notes receivable, and real property described in §1221(1); and
 - e. Property not used in a trade or business or held for investment.
 - **Passive activity loss and credit carryovers.** Any passive activity loss or credit carryover of the taxpayer under I.R.C. §469(b) from the taxable year of the discharge
 - **Foreign tax credit carryovers.** Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under I.R.C. §27

The Amount of Reduction of the Tax Attributes. Except for credit carryovers, the reductions are one dollar for each dollar excluded from income. The reduction of the credits is 33 1/3¢ for each dollar excluded from income (except for the foreign tax credit).

Debt Discharge after Attributes Are Reduced. If the taxpayer's attributes are used up before all of the debt discharged in bankruptcy has been offset by attribute reduction, **the rest of the amount discharged is Not included in income.**

Example 1. James White is an employee of XYZ, Inc. He has no other income, and he recently filed for bankruptcy under Chapter 7. He has no tax attributes other than his bases in assets. James's financial position is as follows:

Assets	FMV	Adjusted Basis	Current Liability
Residence	\$60,000	\$52,000	\$48,000
Auto	12,000	16,000	11,000
Personal property	4,000	12,000	
Credit cards			28,000
Total	\$76,000	\$80,000	\$87,000

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James is current on both his house payment and his car payment, but he is significantly behind on his credit card payment. James will reaffirm both the mortgage on the house and the debt on the car. He will be totally discharged of the \$28,000 in credit card debt. Since James is in **bankruptcy** under the jurisdiction of the court, the debt discharge will be **excluded** from gross income.

James must reduce the bases of his property by the amount of discharged debt (\$28,000). Pursuant to I.R.C. §1017(a), the basis reduction affects the property held by the taxpayer at the **beginning of the tax year that follows the tax year in which the discharge of debt occurs**. Code §1017(b) limits the reduction in basis to not more than the aggregate bases of the property held immediately after the discharge (\$80,000) minus the aggregate of the liabilities immediately after the discharge (\$59,000). As a result, **only \$21,000 (\$80,000 - \$59,000) of the debt discharge of \$28,000 will reduce the basis of his property**.

Since James owns more than one asset after the bankruptcy, Treas. Reg. §1.1017-1(a)(5) requires that the basis of each unit of property be decreased in an amount equal to the proportion that the adjusted basis of each unit of property bears to the sum of the adjusted bases of all such property (i.e., a proportionate allocation using adjusted basis, not fair market value). Accordingly,

<u>Asset</u>	<u>Adjusted Basis</u>	<u>%</u>	<u>Debt Discharge</u>	<u>New Basis</u>
Residence	\$52,000	65	\$13,650	\$38,350
Auto	16,000	20	4,200	11,800
Personal property	12,000	15	3,150	8,850
Total	\$80,000	100	\$21,000	\$59,000

James's adjusted basis for later gain or loss on the sale of these items is reflected in the new basis column at the far right.

Practitioner Note. If James later sells his residence, the first \$13,650 of gain does not qualify for the I.R.C. §121 exclusion and is a 25% gain.

BANKRUPTCY PROCEDURE AND THE BANKRUPTCY ESTATE (IRS PUBLICATION 908)

If an individual debtor files for bankruptcy under Chapter 7 or 11 (not Chapter 12 or 13) of the Bankruptcy Code, a separate "estate" is created consisting of property that belonged to the debtor before the filing date.

This bankruptcy estate is a new taxable entity, **completely separate from the individual debtor**. The estate is managed by a trustee for the benefit of any creditors, and it may produce its own income as well as its own expenses.

INCOME, DEDUCTION, AND CREDITS OF BANKRUPTCY ESTATE

The gross income of the bankruptcy estate of an individual debtor includes any of the debtor's gross income to which the estate is entitled under the bankruptcy law. It does not include amounts the debtor receives or accrues as income before the beginning of the bankruptcy case.

The bankruptcy estate may deduct or take a credit for any expenses it pays or incurs, in the same way that the debtor would have deducted or credited them had he or she continued in the same trade, business, or activity and actually paid or accrued the expenses. Allowable expenses include administrative expenses, such as attorney fees and court costs.

The taxable income of the bankruptcy estate is figured **in the same way** as for an individual. The estate is allowed one personal exemption and either itemized or a standard deduction for a married individual filing separately in arriving at its taxable income. The tax on the taxable income is figured by using the rates for a married individual filing separately.

PARTNERSHIPS AND CORPORATIONS

A separate taxable estate is not created when a partnership or corporation files a bankruptcy petition. The court-appointed trustee is, however, responsible for filing the regular income tax returns on Form 1065 or Form 1120.

TRANSFERS BETWEEN DEBTOR AND BANKRUPTCY ESTATE

A transfer (other than by sale or exchange) of an asset from the individual debtor to the bankruptcy estate is not treated as a “disposition” for income tax purposes. This means that the transfer does not result in gain or loss, recapture of deductions or credits, or acceleration of income or deductions. The estate is treated just as the debtor would be with respect to the transferred asset.

When the bankruptcy estate is **terminated**, that is, dissolved, any resulting transfer (other than by sale or exchange) of the estate's assets to the debtor is not treated as a disposition. Therefore, as with the transfer of an asset to the estate, this transfer does not result in gain or loss, recapture of deductions or credits, or acceleration of income or deductions. The debtor is treated in the same way the estate would be regarding the transferred assets.

USING BANKRUPTCY IN TAX PLANNING

Many taxpayers do not think about income tax planning when they are in financial distress because they assume that income taxes are the least of their problems. In fact, there are significant income tax planning opportunities for taxpayers who are in financial distress and are thinking about filing for bankruptcy. Some of the planning opportunities are outlined below.

DECLARING BANKRUPTCY

The income tax effect of declaring bankruptcy is that slightly different rules apply to debt that is discharged in bankruptcy than to debt that is forgiven while the debtor is not in bankruptcy. **All debt that is forgiven in bankruptcy** qualifies for the §108 rule in that it does not have to be reported as income [I.R.C. §108(a)(1)(A)]. If the debtor is not in bankruptcy when debt is forgiven, the forgiven debt is treated the same as debt discharged in bankruptcy only so long as the debtor is insolvent when the debt is forgiven [I.R.C. §108(a)(1)(B)].

Example 2. Assume a taxpayer has \$525,000 of debts and \$400,000 of assets. If \$200,000 of debts are discharged in bankruptcy, none of the discharge will have to be reported as income. If the same \$200,000 of debt is forgiven outside of bankruptcy, only the first \$125,000 of debt forgiven will be treated like the debt discharged in bankruptcy. The other \$75,000 of debt is income unless it qualifies for one of the other exceptions under I.R.C. §108.

TWO SHORT TAX YEARS

If the debtor elects to declare bankruptcy under either Chapter 7 or 11 of the Bankruptcy Code and has property that is not exempt, he or she will have two options with respect to choosing a tax year:

1. One option is to continue with the same tax year that would have been used if there were no bankruptcy.
2. The other option is to divide the tax year that would have been used if there were no bankruptcy into two short years [I.R.C. §1398(d)].

If the taxpayer elects two short years, the first of the short years ends the day before bankruptcy. The second short year begins on the day of bankruptcy.

Practitioner Note. The election of two short years must be made by the 15th day of the fourth month following the end of the first short year [I.R.C. §1398(d)(2)(D)].

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A separate return must be filed for each of the short years [I.R.C. §1398(d)(2)(E)]. The debtor's income in each of the two short years must be annualized [I.R.C. §§443 and 1398(d)(2)(F)].

Effect of the Election. The option that is chosen may have an effect on whether the debtor or the bankrupt estate pays the taxes, on when and how much of the debtor's tax attributes are absorbed, and on the self-employment taxes that are imposed on the debtor.

Who Pays the Taxes. Since the bankrupt estate is responsible for all of the debtor's liabilities at the time of bankruptcy, income taxes that accrue before the date of bankruptcy become a debt of the estate. [11 U.S.C. §§502(b) and 507(a)(6)(A)]. Consequently, the election to end a tax year before the day of bankruptcy will cause the taxes on the income earned to that point to become a debt of the bankruptcy estate.

- Since income taxes are a priority item in bankruptcy, they will be paid before other debts that may be discharged [11 U.S.C. §507(a)(6)(A)].
- If the election of two short years is not made, the tax on the income earned during the debtor's tax year in which bankruptcy occurs will accrue after the date of bankruptcy and will therefore not become a debt of the estate.

Example 3. To illustrate, assume a calendar-year taxpayer is in financial difficulty and sells some assets in January to pay debts. On March 1 he decides to declare bankruptcy. If he does not elect two short tax years, the gain he realized on the sale of the assets will be included on the return he files for the full year. Those taxes will not be a debt of the bankruptcy estate. If he elects two short tax years, the income taxes on the gain from the sale of the assets will accrue before bankruptcy was declared. Therefore, the taxes on the gain will become a debt of the bankruptcy estate.

Absorption of Attributes. The debtor's selection of a single tax year or two short tax years will also affect the amount of tax attributes that pass from the debtor to the bankrupt estate. The rule is that the bankrupt estate receives the tax attributes of the debtor as of the beginning of the tax year in which bankruptcy occurred [I.R.C. §1398(g)].

Therefore, if the debtor chooses a **single tax year**, the attributes that he or she has at the beginning of that year will pass to the bankrupt estate and cannot be used by the debtor on the tax return for that year.

If the debtor chooses **two short tax years**, the attributes do not pass to the bankrupt estate until the beginning of the second short year. Therefore, the debtor can apply the tax attributes on his or her return for the first short year.

When the bankrupt estate is closed, any remaining attributes pass back to the debtor [I.R.C. §1398(i)]. Therefore, the amount of attributes that is absorbed by the bankrupt estate has some effect on the debtor. The debtor cannot carry the tax attributes from a postpetition year back to a tax year prior to the date of bankruptcy [I.R.C. §1398(j)(2)].

Planning Strategies. If the debtor has income before the date of bankruptcy, it is usually to the debtor's advantage to choose two short years. By doing so, the debtor not only makes the taxes on that income a debt of the estate but also can use the tax attributes before they are passed to the bankruptcy estate to reduce the amount of taxes owed on that income.

If the estate has enough assets to pay the taxes due for the first short year, the reduction in taxes benefits the unsecured creditors of the debtor. If the estate does not have enough assets to pay the tax due for the first short year, the reduction of taxes is a benefit to the debtor, because the taxes will not be discharged in bankruptcy [11 U.S.C. §523(a)(1)(A)] and will become a debt of the debtor when the bankruptcy estate is closed.

Observation. The cost to the debtor of applying the tax attributes to his or her own return by electing two short years is a potential reduction in the amount of tax attributes that pass from the bankrupt estate back to the debtor when the estate is closed. If the bankrupt estate would absorb all the tax attributes anyway, the use of the attributes in the debtor's first short year will have no effect on the attributes that are passed back to the debtor.

Self-employment Taxes. The choice of two short years could increase the amount of self-employment taxes that are imposed on the debtor.

The full base income amount will be applied in each of the two short years. (Rev. Rul. 69-410, 1969-2 C.B.167). Therefore, if the debtor's total wage and self-employment income for the two short years is more than the base amount for that calendar year, more self-employment tax will be imposed with the choice of two short years rather than a single tax year.

The burden of the extra self-employment tax may not fall on the debtor. As noted above, the taxes due for the first short tax year are a debt of the bankrupt estate. If those debts are paid by the bankrupt estate out of assets that would not pass to the debtor anyway, then the extra tax is not a burden to the debtor.

Example 3. To illustrate, assume a taxpayer has \$80,000 of income from the sale of inventory in January 1999. On March 1, 1999, she declares bankruptcy and finds a new job that pays her \$10,000 of wages for the rest of the year.

If she chooses one tax year, the \$10,000 of wages will reduce her self-employment income base to \$62,600, so her self-employment tax would be \$9,905, calculated as follows:

$$\begin{array}{r} 12.4\% \text{ of } \$62,600 = \$7,762 \\ \text{plus } 2.9\% \times \$80,000 \times .9235 = \$2,143 \end{array}$$

If she chooses two short tax years, her self-employment income base will be the full \$72,600 for the first of the two short years. Therefore, she will pay \$11,145 in self-employment taxes, calculated as follows:

$$\begin{array}{r} 12.4\% \text{ of } \$72,600 = \$9,002 \\ \text{plus } 2.9\% \times \$80,000 \times .9235 = \$2,143 \end{array}$$

Under either option, the FICA tax on her wages will be \$765 (7.65% of \$10,000). Therefore, the two-short-year option increases her total social security taxes by \$1,240 (\$11,145 minus \$9,905).

DISCHARGE OF UNPAID TAXES OF DEBTOR (IRS PUBLICATION 908)

As a general rule, there is no discharge for an individual debtor at the termination of a bankruptcy case for prepetition taxes (as defined below) or for taxes for which no return, a late return (filed after a date two years before the filing of the bankruptcy petition), or a fraudulent return was filed. Claims against an individual for other taxes predating the bankruptcy petition by more than three years may be discharged.

PREPETITION TAXES

The following federal taxes are prepetition unsecured priority taxes of the government:

1. Income taxes for tax years ending on or before the date of filing the bankruptcy petition, for which a return is last due (including extensions) after a date three years before the filing of the petition.
2. Income taxes assessed within 240 days before the date of filing the petition. This 240-day period is increased by any time, plus 30 days, during which an offer in compromise with respect to these taxes was pending, that was made within 240 days after the assessment.

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3. Income taxes, other than those for which no return, a later return (filed within two years of the filing of the bankruptcy petition), or a fraudulent return was filed, that were not assessed before but are assessable after the filing of the petition.
4. Withholding taxes on which the debtor is liable in any capacity.
5. Employment taxes on the first \$2,000 of wages, salaries, or commissions (including vacation, severance, and sick leave pay) earned by each individual employee from the debtor within the 90-day period before the earlier of the date of cessation of the debtor's business or the date of filing bankruptcy petition (whether or not actually paid before the date), and employment taxes for which a return is last due (including extensions) after a date three years before the filing of the petition.
6. Excise taxes on transactions occurring before the date of filing the bankruptcy petition, for which a return, if required, is last due (including extensions) after a date three years before the filing of the petition. If a return is not required, these excise taxes include only those on transactions occurring during the three years immediately before the date of filing the petition.
7. Taxes arising in the ordinary course of the debtor's business or financial affairs in an involuntary bankruptcy case, after the filing of the bankruptcy petition but before the earlier of the appointment of a trustee or the order for relief.

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