TROUBLESOME AREAS OF RECENT LEGISLATION

1999 Income Tax School

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1. IRS COLLECTION DIVISION ISSUES

The Internal Revenue Service Restructuring and Reform Act of 1998 required the IRS to change many facets of the collection process, including the rights of taxpayers under collection proceedings, and made specific modifications to the offer in compromise rules. The most notable of these changes are as follows.

A. INSTALLMENT AGREEMENT

The act requires the IRS to enter into an installment agreement, **at the taxpayer's option, if all five following conditions are met:**

1. The tax liability is $10,000 or less (excluding penalties and interest);
2. Within the **previous five years,** the taxpayer has **not** failed to file or pay, nor entered into a previous installment agreement;
3. If requested by the IRS, the taxpayer submits financial statements and the IRS determines that the taxpayer is unable to pay the tax in full;
4. The installment agreement provides for full payment of the liability **within three years;** and
5. The taxpayer agrees to comply with the tax laws and the terms of the agreement while the agreement is in effect.

This provision is effective for installment agreements submitted after July 22, 1998 [I.R.C. §6159(c)].

Practitioner Caution. As explained in IRS Publication 954, *The IRS Collection Process,* an installment agreement is more costly than paying all the taxes owed and is generally more costly than borrowing funds to fully pay the IRS. In addition, the IRS charges a $43 user fee to set up an installment agreement.

B. INCREASE IN CERTAIN LEVY EXEMPTION AMOUNTS UNDER I.R.C. §6334

The levy exemption amount for "fuel, provisions, furniture, and personal effects" is increased from $2,500 to $6,250. The exemption amount for "books and tools of a trade, business, or profession" is increased from $1,250 to $3,125.

These provisions are effective for levies issued after July 22, 1998.

C. RIGHTS OF TAXPAYERS ENTERING INTO OFFERS IN COMPROMISE UNDER I.R.C. §§6331 AND 7122

The 1998 act significantly impacted the IRS offer in compromise program as follows:

1. The IRS is required to develop and publish schedules of national and local allowances that will provide taxpayers entering into an offer in compromise with adequate means to provide for basic living expenses [I.R.C. §7122(c)(2)(A)].
2. IRS personnel are required to consider the facts and circumstances of a particular taxpayer's case in determining whether the national and local schedules are adequate [I.R.C. §7122(c)(2)(B)].
3. The IRS cannot reject an offer from a **low-income taxpayer** solely on the basis of the amount of the offer [I.R.C. §7122(c)(3)(A)].
4. The IRS cannot request a financial statement if the taxpayer makes an offer based solely on **doubt as to liability** [I.R.C §7122(c)(3)(B)(ii)].
5. The IRS cannot collect a tax liability by **levy:**
    - During any period that a taxpayer's offer for that liability is being processed,
    - During the 30 days following rejection of an offer, and
    - During any period in which an appeal of the rejection of an offer is being considered [I.R.C. §6331(k)].
6. The IRS must implement procedures to **review** all proposed IRS **rejections** of taxpayer offers in compromise and requests for installment agreements prior to the rejection being communicated to the taxpayer [I.R.C. §7122(d)(1)].
7. The congressional conference committee report expresses the beliefs that:
    - The ability to compromise tax liability enhances taxpayer compliance.
    - The IRS should be more flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system.
    - The IRS should make it easier for taxpayers to enter into offer in compromise agreements.
    - The IRS should do more to educate taxpayers about the availability of offer in compromise agreements.

NEW OFFER IN COMPROMISE GUIDELINES

The IRS issued a new Form 656 (Rev. 2–1999) and extensive instructions for use in preparing the form. For the first time, specific instructions are provided that clearly indicate how the Form 656 and Forms 433-A and 433-B (Collection Information Statements) are to be used in calculating the amount of the offer. The most difficult issue is to determine which of the three offer choices to use when submitting an offer in a **"doubt as to collectibility"** case.

The decision process starts with item 7 of Form 656. The taxpayer is now given **three choices** when making an offer:

1. Cash offer
2. Short-term deferred payment offer
3. Deferred payment offer

Complexity arises in the computation of the **offer amount,** as that amount will be different for each option. Since an offer in compromise is based on **two** components, **positive equity in assets and projected cash flow on a monthly basis,** the starting amount for each offer will be the same. However, the correct offer amount can be significantly different for each option. Pages 7 and 8 of the new instructions provide specific details on the computation of each of the two components of an offer in compromise.

To illustrate the computation of the offer amount under each of the three choices, assume the following:

Tax year of unpaid liability	1994
Total tax, penalty, and interest owed	$32,000
Date assessed	June 1, 1996 (late filed Form 1040)
Positive equities (quick sale)	$7,000
Projected monthly cash flow	$200
Offer in compromise date	December 1, 1999
Remaining months in 10-year statutory period	78 (12-1-99 through 5-31-06)

1. Cash Offer

Computation for a Cash Offer Amount

Realizable values of assets	$ 7,000
plus	
Amount IRS could collect over 48 months of payments ($200 a month × 48 months)	9,600
Amount of cash offer	**$ 16,600**

The calculated amount of the **cash offer** is $16,600. Assuming the IRS agrees with the information provided by the taxpayer to support the assumed facts, the $16,600 offer will be accepted.

> **Note.** Whether the taxpayer owes $32,000 or $320,000 is irrelevant. The correct amount to offer under the cash offer formula is $16,600. **A cash offer must be paid within 90 days of acceptance.**

When the 10-year statutory collection period expires in **less than 48 months,** a different calculation must be used for a cash offer. Assume the same facts as above except that there are only **37 months** remaining in the 10-year period. The Deferred Payment Offer chart on page 9 of the Form 656 instructions must be used to compute the cash offer amount. The chart shows that **33 months** (rather than the normal 48 months) of payments are required. Therefore, the correct amount of the offer is:

Realizable value of assets	$ 7,000
plus	
Amount IRS could collect over 33 months of payments ($200 a month × 33 months)	6,600
Amount of cash offer when the remaining collection period is at least 36 months but less than 48 months (37 months in this case)	**$13,600**

2. Short-Term Deferred Payment Option

This option requires the taxpayer to pay the offer amount **within two years of acceptance.** Interest continues to run during the period of the two-year payment schedule, although the failure-to-pay penalty does not. A short-term deferred payment offer must include the realizable value of assets *plus* the amount of monthly cash flow for a **60-month period** (not 48, as for a cash offer).

Computation for a Short-Term Deferred Payment Offer Amount

Realizable value of assets	$ 7,000
plus	
Amount IRS could collect over 60 months of payments ($200 a month × 60 months)	12,000
Amount of short-term deferred payment offer	**$ 19,000**

Note. $19,000 divided by the 24-month payment period results in monthly payments to the IRS of $791.67 **plus** interest at the applicable quarterly rate.

When the 10-year statutory collection period expires in **less than 60 months,** a different offer calculation applies.

Assume the same facts except that there are only **37 months** remaining in the 10-year period. The Deferred Payment Offer chart on page 9 of the Form 656 instructions must be used to compute the short-term deferred payment offer amount. Therefore, the correct amount of the offer is:

Realizable value of assets	$ 7,000
plus	
Amount IRS could collect over 33 months of payments ($200 a month × 33 months)	6,600
Amount of short-term deferred payment offer when the remaining collection period is at least 36 months but less than 48 months	**$13,600**

Note. If the taxpayer can afford to pay a total of **only $200 a month** for the 33-month period, it will take an **additional 3 months** of $200 payments to pay the interest due. This assumes a 7% interest rate. See page 9 of the Form 656 instructions.

3. Deferred Payment Offer

The deferred payment offer is the result of a change in IRS philosophy regarding the acceptance of certain minimum payment installment agreements. Many practitioners have clients who owe the IRS large amounts of money but are able to make only a token payment on a monthly basis. The current IRS position is that unless the total liability, including interest and penalty accruals, can be paid off within the remaining 10-year statutory collection period *plus* 5 years, an installment agreement will **not** be offered to the taxpayer. The IRS would rather have an offer in compromise made in this situation, and the deferred payment offer was created for it.

The deferred payment offer is generally the most difficult to compute. Payments are made during the remaining life of the 10-year statutory collection period. **Three different payment options are available under a deferred payment offer.** Interest continues to run, although the failure-to-pay penalty does not. The complexity increases when there is more than one tax year included in the offer. In the example shown below, **payment option 3** is chosen. In **option 3**, the entire offer amount is paid monthly over the remaining life of the 10-year collection period.

Assume the same facts shown prior to the first choice, the cash offer. Those facts indicate that there are **78 months** remaining in the 10-year collection period. The Deferred Payment Offer chart must be

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used to compute the deferred payment offer amount. The chart shows that **59 months** of cash-flow payments are required. Therefore, the correct amount of the offer is:

Realizable value of assets	$ 7,000
plus	
Amount IRS could collect over 59 months of payments ($200 a month × 59 months)	11,800
Amount of deferred payment offer	**$18,800**

Note. If the taxpayer can afford to pay a total of **only $200 a month** for the 59-month payment period, it will take **an additional 13 months** of $200 payments to pay the interest due. This assumes a 7% interest rate. See page 9 of Form 656 instructions.

4. Economic Hardship Provisions under Temporary and Proposed Regulations Issued July 19, 1999

The following article appeared in the Fall 1999 edition of the *Fed-State Illinois Tax Review,* a quarterly publication for Illinois tax practitioners. It was written by the Illinois District of the Internal Revenue Service in July 1999.

Some taxpayers facing **severe or unusual economic hardships** will have a new way of settling their tax debts under a new Internal Revenue Service plan. Under new regulations filed with the Federal Register on July 19, the IRS (for the first time) will be allowed to consider **economic hardship factors** in cases where taxpayers try to settle unpaid tax debts through the Offer in Compromise program and **where settlements would promote effective tax administration.**

This change expands the Offer in Compromise program and allows the IRS to negotiate a settlement with people unable to pay their entire tax bill. Prior to the new regulations, the IRS could accept the taxpayer's Offer in Compromise only when there was doubt about whether the tax debt could ever be collected or doubt as to whether it was owed.

The provision outlined in the temporary regulations (T.D. 8299) creates a **new category** of Offer in Compromise (OIC). Under this new provision, taxpayers may be eligible for an OIC if:

- **Collection of the entire tax liability would create economic hardship, or exceptional circumstances exist where collection of the entire tax liability would be detrimental to voluntary compliance.**

According to the regulations, an Offer in Compromise cannot be approved in situations where it would undermine compliance with the tax laws. **To qualify, taxpayers also must have a history of paying and filing their taxes.**

The temporary regulations outline several possible **examples** where taxpayers might qualify for the new type of Offer in Compromise.

- Economic hardship can include taxpayers (and their dependents) facing a **long-term illness, medical condition, or disability** where the person's financial resources will be exhausted while providing for care and support. An example is a parent who has assets large enough to pay the tax bill, but those assets will be needed for care of a child with a long-term illness.
- Economic hardship can also cover cases where the sale or liquidation of assets to pay the tax bill would prevent the taxpayer from meeting basic living expenses. For example, a retiree has a retirement fund large enough to pay the tax bill, but using the fund would deprive the person of basic living expenses.

- Also, an Offer in Compromise may be granted under **exceptional circumstances**, such as extraordinary events beyond a taxpayer's control. An example is someone who was hospitalized for several years, could not manage any financial affairs, and was unable to file tax returns.

We are nearing completion on a **new application form** for the special Offer in Compromise category–**Form 656-A.** This new form will be submitted **in addition to** Form 656, the standard Offer in Compromise application.

When the taxpayer submits Form 656-A applications, the IRS will first determine whether the taxpayer is eligible for one of the traditional Offer in Compromise options. If the taxpayer is not, then we will consider the application under the new economic hardship provisions.

Keep in mind that this new program is only for taxpayers entangled in very severe circumstances and is not designed to be a sweeping program for everyone with financial difficulties or a panacea for people with tax problems.

We anticipate implementing these temporary regulations and beginning to process applications around mid- to late September. This will give us enough time to finalize new procedures, print new forms, and train collection employees on the new guidelines.

The temporary regulations outlining these new rules will be in effect **for three years.** This will give the IRS an opportunity to monitor the program's progress and get feedback from tax practitioners and others.

5. Procedural Instructions from the IRS Regarding Offers in Compromise

The following article was written by the Illinois District of the Internal Revenue Service in July 1999.

If you are considering an Offer in Compromise for one of your clients, **you need to ensure that the taxpayer is compliant**. In other words, **all returns must have been filed. We will not be able to process the offer if all returns have not been filed.** In addition, for an in-business taxpayer to demonstrate "compliance" when filing an Offer in Compromise for employment taxes, their **employment tax returns should have been filed and all taxes paid for the previous two quarters.** The fact that a taxpayer is not current on federal tax deposits and/or estimated payments could affect acceptance of the offer. Also, we do **not** process Offers in Compromise when the taxpayer is in **bankruptcy.**

The next step is to prepare Form 656, Offer in Compromise, and Form 433A, Collection Information Statement for Individuals, and/or Form 433B, Collection Information Statement for Business–for offers based on doubt as to collectibility. For an in-business taxpayer who owes employment taxes (which includes trust fund liabilities) and where assessment of the trust fund recovery penalty is applicable or possible, you also need to include a Form 433A for each person who is liable or potentially liable for the trust fund recovery penalty.

Then you also need to determine which type of offer would best serve your client:

- Cash offer (paid within 90 days)
- Short-term deferred offer (paid within 90 days to two years)
- Deferred offer (paid within the statutory period of collection)

There are a few issues to look at when considering these options. Cash offers will expedite release of the lien because the lien is released after the offer amount plus interest is paid. Also, we would not normally file a lien if one was not already filed. With short-term deferred offers, a lien-filing determination is made on the individual case. And, if a deferred offer is made, we would also make a lien-filing determination based on the facts of the case. **If we decide to file a lien (or if a lien has already been filed), the lien would not be released until the offer amount and interest are paid.**

It is critical that the following information is included on or with the Form 656: signatures (both husband and wife must sign with a joint offer), the tax liabilities to be compromised (tax years, tax form numbers, and amounts), and the amount offered (this amount should be equal to or exceed the taxpayer's equity in assets). When you are ready to submit the offer, make sure all the blocks are filled out on the Form 656 and that the type of offer being submitted is checked.

Once we receive an offer, it is date-stamped and input into our offer database. The offer is then reviewed to ensure that it can be perfected for processing. If we are not able to process the offer for compliance or bankruptcy issues, it will be returned along with a letter outlining the reason. All other offers will begin the processing stage. If additional information is needed, we will contact the taxpayer or their power of attorney by phone and/or mail. **Some of the issues we often need to contact the taxpayer or power of attorney about are:**

- No money offered.
- Preprinted terms on Form 656 have been altered.
- Two names are listed on Form 656, but only one signature.
- Taxpayer identification number is not included or is incorrect.
- Form 433A or B is missing.
- All relevant tax periods are not listed on Form 656.
- Both joint and individual liabilities are listed on the same offer.

Letters requesting additional information will ask for a response within 14 days. If we don't receive a response, a second letter allowing an additional 14 days is sent. If we don't receive a response from this letter, we will return the offer as unprocessable.

Once an offer is perfected, the waiver on Form 656 is signed and the taxpayer or their representative is sent a letter advising them that they will be contacted within 45 days by the Offer in Compromise specialist assigned to investigate the offer. **Once an Offer in Compromise specialist is assigned, the investigation phase of the process should be completed within six months.**

The following blank forms and certain pages of instructions are shown next:

- Form 656 (Rev. 2–1999)
- Pages 5, 7, 8, and 9 of Form 656 instructions

Note. The Deferred Payment Offer chart is on page 9 of the Form 656 instructions.

Department of the Treasury
Internal Revenue Service

www.irs.ustreas.gov

Form 656 (Rev. 2-1999)
Catalog Number 16728N

Form 656
Offer in Compromise

Item 1 — **Taxpayer's Name and Home or Business Address**

____
Name
____
Street Address
____

____
City State ZIP Code

Mailing Address *(if different from above)*

____
Street Address
____
City State ZIP Code

Item 2 — **Social Security Numbers**

(a) Primary _______________________________________

(b) Secondary _____________________________________

Item 3 — **Employer Identification Number** *(included in offer)*

____

Item 4 — **Other Employer Identification Numbers** *(not included in offer)*

____
____
____

Item 5 — **To: Commissioner of Internal Revenue Service**

I/We (includes all types of taxpayers) submit this offer to compromise the tax liabilities plus any interest, penalties, additions to tax, and additional amounts required by law (tax liability) for the tax type and period marked below: (Please mark an "X" in the box for the correct description and fill-in the correct tax period(s), adding additional periods if needed).

❑ **1040/1120 Income Tax** — Year(s) _______________________
____

❑ **941 Employer's Quarterly Federal Tax Return** — Quarterly period(s) _______________________________________
____

❑ **940 Employer's Annual Federal Unemployment (FUTA) Tax Return** — Year(s) _______________________________
____

❑ **Trust Fund Recovery Penalty** as a responsible person of (enter corporation name) _______________________________
____
for failure to pay withholding and Federal Insurance Contributions Act Taxes (Social Security taxes), for period(s) ending _______________________________ .

❑ **Other Federal Tax(es)** [specify type(s) and period(s)] ________
____

Note: ***If you need more space, use another sheet titled "Attachment to Form 656 Dated _______________ ." Sign and date the attachment following the listing of the tax periods.***

Item 6 — I/we submit this offer for the reason(s) checked below:

❑ **Doubt as to Liability** — "I do not believe I owe this amount." You must include a detailed explanation of the reasons why you believe you do not owe the tax.

❑ **Doubt as to Collectibility** — "I have insufficient assets and income to pay the full amount." You *must* include a complete financial statement, Form 433-A and/or Form 433-B.

Item 7

I/we offer to pay $ ______________

❑ Paid in full with this offer.

❑ Deposit of $ _____________ is attached to this offer.

❑ No deposit.

Note: ***Make all checks payable to: The United States Treasury***

Check one of the following:

❑ **Cash Offer (Offered amount will be paid in 90 days or less)**

Balance to be paid in: _______ 10, _______ 30, _______ 60, or _________ 90 days from notice of acceptance of the offer. If more than one payment will be made during the time frame checked, provide the amount and date of the payment on the line below.

____

❑ **Short Term Deferred Payment Offer (offered amount paid in more than 90 days but within 24 months)**

Amount of monthly payment _____________________________

Monthly payment date __________________________________

Balance will be fully paid on _____________________________

Other terms for payment _______________________________

❑ **Deferred Payment Offer (offered amount will be paid over the life of the collection statute)**

Amount of monthly payment _____________________________

Monthly payment date __________________________________

Other terms for payment _______________________________

Note: ***In addition to the above amounts (for both cash and deferred offers), the Internal Revenue Service (IRS) will add interest from the date we accept the offer until you completely pay the amount offered, as required by section 6621 of the Internal Revenue Code. We compound interest daily, as required by section 6622 of the Internal Revenue Code.***

Item 8: **By submitting this offer, I/we understand and agree to the following conditions:**

(a) I/we voluntarily submit all payments made on this offer.

(b) The IRS will apply payments made under the terms of this offer in the best interest of the government.

[*continues*]

(c) If the IRS rejects the offer or I/we withdraw the offer, the IRS will return any amount paid with the offer. If I/we agree in writing, IRS will apply the amount paid with the offer to the amount owed. If I/we agree to apply the payment, the date the IRS received the offer remittance will be considered the date of payment. I/we understand that the IRS will not pay interest on any amount I/we submit with the offer.

(d) I/we will comply with all provisions of the Internal Revenue Code relating to filing my/our returns and paying my/our required taxes for 5 years or until the offered amount (plus accrued interest) is paid in full, whichever is longer. In the case of a jointly submitted offer to compromise joint tax liabilities, I/we understand that default with respect to the compliance provisions described in this paragraph by one party to this agreement will not result in the default of the entire agreement. The default provisions described in Item 8(o) of this agreement will be applied only to the party failing to comply with the requirements of this paragraph. This provision does not apply to offers based on Doubt as to Liability.

(e) I/we waive and agree to the suspension of any statutory periods of limitation (time limits provided for by law) for the IRS assessment and collection of the tax liability for the tax periods identified in Item 5. I/we understand that this waiver provision will have no effect after December 31, 2002.

(f) The IRS will keep all payments and credits made, received or applied to the total original tax liability before submission of this offer. The IRS may keep any proceeds from a levy served prior to submission of the offer, but not received at the time the offer is submitted. If I/we have an installment agreement prior to submitting the offer, I/we must continue to make the payments as agreed while this offer is pending. Installment agreement payments will not be applied against the amount offered.

(g) The IRS will keep any refund, including interest, due to me/us because of overpayment of any tax or other liability, for tax periods extending through the calendar year that the IRS accepts the offer. I/we may not designate an overpayment ordinarily subject to refund, to which the IRS is entitled, to be applied to estimated tax payments for the following year. This condition does not apply if the offer is based on Doubt as to Liability.

(h) I/we will return to the IRS any refund identified in (g) received after submission of this offer. This condition does not apply to offers based on Doubt as to Liability.

(i) The IRS cannot collect more than the full amount of the tax liability under this offer.

(j) I/we understand that I/we remain responsible for the full amount of the tax liability, unless and until the IRS accepts the offer in writing and I/we have met all the terms and conditions of the offer. The IRS will not remove the original amount of the tax liability from its records until I/we have met all the terms of the offer.

(k) I/we understand that the tax I/we offer to compromise is and will remain a tax liability until I/we meet all the terms and conditions of this offer. If I/we file bankruptcy before the terms and conditions of this offer are completed, any claim the IRS files in the bankruptcy proceedings will be a tax claim.

(l) Once the IRS accepts the offer in writing, I/we have no right to contest, in court or otherwise, the amount of the tax liability.

(m) The offer is pending starting with the date an authorized IRS official signs this form and accepts my/our waiver of the statutory periods of limitation. The offer remains pending until an authorized IRS official accepts, rejects or acknowledges withdrawal of the offer in writing. If I/we appeal the IRS decision on the offer, the IRS will continue to treat the offer as pending until the Appeals Office accepts or rejects the offer in writing. If I/we don't file a protest within 30 days of the date the IRS notifies me/us of the right to protest the decision, I/we waive the right to a hearing before the Appeals Office about the offer in compromise.

(n) The waiver and suspension of any statutory periods of limitation for assessment and collection of the amount of the tax liability described in Item 5, continue to apply:

- **while the offer is pending [see (m) above]**
- **during the time I/we have not paid all of the amount offered**
- **during the time I/we have not completed all terms and conditions of the offer**
- **for one additional year beyond each of the time periods identified in this paragraph**

(o) If I/we fail to meet any of the terms and conditions of the offer and the offer defaults, then the IRS may:

- immediately file suit to collect the entire unpaid balance of the offer
- immediately file suit to collect an amount equal to the original amount of the tax liability as liquidating damages, minus any payment already received under the terms of this offer
- disregard the amount of the offer and apply all amounts already paid under the offer against the original amount of the tax liability
- file suit or levy to collect the original amount of the tax liability, without further notice of any kind.

The IRS will continue to add interest as required by Section 6621 of the Internal Revenue Code, on the amount the IRS determines is due after default. The IRS will add interest from the date the offer is defaulted until I/we completely satisfy the amount owed.

(p) The IRS generally files a Notice of Federal Tax Lien to protect the Government's interest on deferred payment offers. We will release this tax lien when the offered amount plus any accrued interest has been fully paid.

Item 9

If I/we submit this offer on a substitute form, I/we affirm that this form is a verbatim duplicate of the official Form 656, and I/we agree to be bound by all the terms and conditions set forth in the official Form 656.

Under penalties of perjury, I declare that I have examined this offer, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct and complete.

____
9(a) Signature of Taxpayer — proponent

____
Date

____
9(b) Signature of Taxpayer — proponent

____
Date

For Official Use Only

I accept the waiver of the statutory period of limitations for the Internal Revenue Service.

____
Signature of Authorized Internal Revenue Service Official

____
Title

____
Date

Payment Terms for Offers in Compromise

You can pay three ways:

1. Cash (paid in 90 days or less),

2. Short-Term Deferred Payment (more than 90 days, up to 24 months), or

3. Deferred Payment (offers with payment terms over the remaining statutory period for collecting the tax.).

Note: In all three cases, we will release any filed Notice of Federal Tax Lien once you have fully paid the offer amount and any interest that has accrued.

Cash Offer

You must pay cash offers within 90 days of acceptance.

You should offer the realizable value of your assets plus the total amount we could collect over forty-eight months of payments. When the ten-year statutory period for collection expires in less than forty-eight months, you must use the Deferred Payment Chart on page 9. We charge interest on the offer amount from the acceptance date until we receive full payment.

Short-Term Deferred Payment Offer

This payment option requires you to pay the offer within two years of acceptance.

The offer must include the realizable value of your assets in addition to the total amount the IRS could secure over sixty months (or the remainder of the ten-year statutory period for collection, whichever is less) through monthly payments.

We may file a Notice of Federal Tax Lien on tax liabilities compromised under short-term payment offers.

Deferred Payment Offers

This payment option requires you to pay the offer amount within the remaining statutory period for collecting the tax.

The offer must include the realizable value of your assets plus the amount we could collect through monthly payments during the remaining life of the collection statute.

The deferred payment option itself has three payment options:

1) Option One is:

- Full payment of the realizable value of your assets within 90 days from the date we accept your offer and
- Your future income in monthly payments during the remaining life of the collection statute

2) Option Two is:

- Cash payment for a portion of the realizable value of your assets within 90 days from the date we accept your offer and
- Monthly payments during the remaining life of the collection statute for both the balance of the realizable value and your future income

3) Option Three is:

- The entire offer amount in monthly payments over the life of the collection statute.

Just as with short-term deferred payment offers, we may file a Notice of Federal Tax Lien.

Note: The worksheet on page 7 instructs you how to calculate the appropriate amount for a Cash, Short-Term Deferred Payment, or Deferred Payment Offer.

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Form 656 Instructions, page 5

Worksheet to Calculate An Offer Amount Using Forms 433-A and/or 433-B

You need to prepare a financial statement before you can determine the amount you should offer. We use Form 433-A or Form 433-B, *Collection Information Statement*, for most purposes. Individual taxpayers should prepare a Form 433-A using Publication 1854 for instructions. Self-employed taxpayers should prepare a Form 433-A and a Form 433-B, the statement we use for businesses; Corporations and other types of businesses should prepare a Form 433-B.

Terms and Definitions

An understanding of the following terms and conditions will help you when you prepare your offer.

Current (Fair) Market Value (FMV) — The amount you could reasonably expect from the sale of an asset. Don't guess at the asset's value. Determine it from realtors, used car dealers, publications, furniture dealers, or other experts on specific types of assets. Please include a copy of any written estimate with your financial statement.

Quick Sale Value (QSV) — The amount you could reasonably expect from the sale of an asset if you sold it quickly, typically in ninety days or less. This amount generally is less than fair market value.

Realizable Value — The quick sale value amount minus what you owe to a secured creditor. The creditor must have priority over a filed Notice of Federal Tax Lien before we allow a subtraction from the asset's value.

Future Income — We generally determine the amount we could collect from your future income by subtracting necessary living expenses from your monthly income over a set number of months. For a cash offer, you must offer what you could pay in monthly payments over forty-eight months. For a short-term deferred payment offer, you must offer what you could pay in monthly payments over sixty months. For a deferred payment offer, you must offer what you could pay in monthly payments over the remaining life of the collection statute.

Necessary Expenses — (This expense allowance does not apply to business entities). When we determine monthly payments, we allow you the expenses you need to support you and your family's health and welfare and/or the production of income. Our Publication 1854 explains the National Standard Expenses and gives the allowable amounts. We derive these amounts from the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey. We also use information from the Bureau of the Census to determine local expenses (housing, utilities, and transportation).

Note: If the IRS determines that the facts and circumstances of your situation indicate that using the scheduled allowance of necessary expenses is inadequate, we will allow you an adequate means for providing basic living expenses. However, you must provide documentation that supports a determination that using national and local expense standards leaves you an inadequate means of providing for basic living expenses.

Expenses Not Generally Allowed — We typically do not allow you to claim tuition for private schools, public or private college expenses, charitable contributions, voluntary retirement contributions, payments on unsecured debts such as credit card bills, cable television charges and other similar expenses as necessary living expenses. However, we can allow these expenses when you can prove that they are necessary for the health and welfare of you or your family or for the production of income.

WORKSHEET

1. Enter the total amount of cash you currently have available. Include cash, savings, checking account balance minus your monthly necessary living expenses, cash value in life insurance policies, and securities (Items 20, 21, 22, and 23 of Form 433-A and/or Items 16,17,18, & 19 of Form 433-B). $ ____________

2. Enter the value of any retirement plans (*e.g.*, IRA, 401-K, etc.) from which you can cash out or borrow funds minus the amount of tax (federal, state and local) and early withdrawal penalty you incur by withdrawing these funds. $ ____________

Form 656 Instructions, page 7

3. The following schedule helps you calculate the realizable value of your assets:

- Enter the current Fair Market Value (FMV) in column (B) for each asset listed on Form 433-A, Items 24, 25, and 26, and/or Form 433-B, Items 20 through 24
- Calculate the Quick Sale Value (QSV) by taking 80% of the Fair Market Value of each asset
- Enter that amount in column (C)
- Enter the amount owed (liability) to any secured creditor in column (D)
- Subtract the amount in column (D) from the amount in column (C) to get the realizable value
- Enter that amount in column (E)

Don't show negative value on assets for which you owe more than their worth. Show realizable value as $0.00 for cases like these.

***Note:** We may not allow the amount owed to a secured creditor as a liability unless it has priority over a filed Notice of Federal Tax Lien.*

(A) ASSET	(B) FMV	(C) QSV	(D) LIABILITY	(E) REALIZABLE VALUE
1998 truck	20,000	16,000	12,000	$ 4,000
Real property	100,000	80,000	96,000	0
			TOTAL	$ 4,000

ASSET	FMV	QSV	LIABILITY	REALIZABLE VALUE

(Attach Additional Sheets if Needed)

TOTAL $ ______________

***NOTE:** **Individuals** may exclude the value of the following:*

- ***$6,250 of the value of your furniture or personal effects in your household items of personal use, livestock or poultry. Don't include the value of your vehicle in this exclusion.***
- ***$3,125 of the value of trade or business tools.***

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4. To calculate monthly payments:
   a. Enter total monthly income (Item 41, Form 433-A) here $ ______________
   b. Enter necessary monthly living expenses (Item 52) here $ ______________
   c. Subtract b from a: enter the monthly payment result here $ ______________
   (This amount cannot be less than $0)

NOTE: Decide now to make either a Cash or a Deferred Payment Offer.

For a **Cash Offer**, multiply line c by 48. Interest accrues from the date we accept the offer until it is fully paid. $ ______________

For a **Short-Term Deferred Payment Offer**, multiply line c by 60. You will owe interest on these deferred payments. $ ______________

Form 656 Instructions, page 8

Note: In cases where the tax liability has less than five years remaining on the collection statute, for both Cash and Short-Term Deferred Payment Offers, you must multiply line c by the number of months indicated in the Deferred Payment Offer Chart).

For a **Deferred Payment Offer**, you need to use the Deferred Payment Offer Chart below.

- First, find the number of years remaining on the collection statute in Column I. (Call your local IRS office or 1–800–829–1040 if you need help in determining the time left).
- Then go to Column III to find the number of monthly payments to apply to your offer.
- Finally, multiply the amount on line c by the number of monthly payments identified in the Deferred Payment Offer Chart.

You will owe interest on these deferred payments. $ ________________

5. **AMOUNT OF OFFER** (Add lines 1, 2, 3 and 4) $ ________________

Deferred Payment Offer Chart

I Years Remaining on the Collection Statute	II Total Monthly Payments*	III Number of Monthly Payments Applied to Offered Amount	IV Number of Monthly Payments Applied to Interest*
9 to *Less than* 10	108	80	28
8 to 9	96	74	22
7 to 8	84	67	17
6 to 7	72	59	13
5 to 6	60	51	9
4 to 5	48	42	6
3 to 4	36	33	3
2 to 3	24	22	2
1 to 2	12	11	1

* The above chart is based on an interest rate of 7%, which by law, is subject to change. The actual number of interest payments and total payments depends on the applicable interest rates during the course of the agreement (increases in the interest rate cause additional payments, decreases result in fewer payments). Use of this chart, after a change in the interest rate, will not cause us to reject your offer.

SELF-EMPLOYED TAXPAYERS must add the assets listed on Form 433-B to the above amounts. Calculate the monthly net income from your business and transfer that amount to Form 433-A, Item 34.

Form 656 Instructions, page 9

2. IDENTIFICATION OF RETURN PREPARERS: NEW FORM FOR ALTERNATIVE IDENTIFICATION NUMBER

Due to consistent complaints from the tax practitioner community regarding privacy issues, Congress mandated in the IRS Restructuring and Reform Act of 1998 that the IRS develop an alternative to the social security number requirement on tax returns prepared for compensation. **Form W-7P** (August 1999) was developed for this purpose. A proof copy dated 6/10/99 is included for reference.

The alternative number, referred to as a PTIN (Preparer Tax Identification Number), can be used in place of the social security number of the preparer. It is not mandatory, and preparers can continue to use their SSNs. The PTIN **cannot** be used in place of the employer identification number (EIN) of the tax preparation firm.

The PTIN will be a nine-digit number, starting with the letter P and followed by eight numbers. There is no dash between the letter P and the eight numbers. Form W-7P can be either faxed or mailed to the IRS, and phone numbers and addresses are provided on the form. The IRS will mail the PTIN to the practitioner. A practitioner may also be able to complete the application over the Internet.

Preparers will be able to access, download, and print the Form W-7P from "News for Tax Professionals" on the IRS website, or call toll-free 1-800-829-3676 for a copy. PTINs will first be issued in early October, and applications received by mid-November should be processed in time for the 2000 filing season.

Form **W-7P**
(August 1999)
Department of the Treasury
Internal Revenue Service

Application for Preparer Tax Identification Number

1 Name (Type or print)	Last name	First name	Middle name/Initial
2 Address (residence)	Street address. Use a P.O. box number only if the post office does not deliver mail to your street address.		
	City or town, state/province, and, if outside the U.S., country. Include ZIP or postal code where appropriate. Do not abbreviate name of country.		
3 SSN and Date of Birth	**SSN** ☐☐☐ - ☐☐ - ☐☐☐☐		Date of birth (month, day, year) / /
Sign Here	Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete. Further, I certify that I will use my preparer tax identification number only to identify myself on returns or claims for refund that I prepare for compensation.		
	Your signature ▶	Date (month, day, year) / /	Phone number ( )

Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form. Use this form to apply for a preparer tax identification number (PTIN) **only** if you are a paid tax return preparer and you do not want to disclose your social security number (SSN) on returns you prepare. If you use a PTIN, you will meet the requirement under section 6109(a)(4) of furnishing your identifying number on returns you prepare. The PTIN cannot be used in place of the employer identification number (EIN) of the tax preparation firm.

Note: *You are not required to get a PTIN. If you prefer, you may continue to use your SSN on tax returns you prepare.* ***However,*** *you must use either an SSN or PTIN on returns you are paid to prepare. Do not write "PTIN applied for" in the Paid Preparer's Use Only section of the return. Certain states and localities may not accept the PTIN as satisfying a requirement for a preparer identification number on their tax returns.*

How To Apply

- **By mail:** Complete Form W-7P and send it to:

  Internal Revenue Service
  Philadelphia Service Center
  PTIN Unit
  P.O. Box 447
  Bensalem, PA 19020

- **By fax:** Complete Form W-7P and fax it to **1-215-516-1127.**

You will receive your PTIN by **mail only.** If you have not heard from the IRS within 6 weeks after applying for your number, you may call 1-800-829-1040 (or 1-215-516-4846 outside the United States) to check on the status of your application.

Privacy Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. Section 3710 of the Internal Revenue Service Restructuring and Reform Act of 1998 allows the use of a PTIN. If you request a PTIN, you must give us the information requested on this form; we need it to properly respond to your request. Under section 6109, you must provide your social security number on Form W-7P. Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and to cities, states and the District of Columbia for use in administering their tax laws. If you do not provide all of the requested information, we may be unable to process your request.

3. SALE OR EXCHANGE OF A PRINCIPAL RESIDENCE: THE USUAL ISSUES

The Taxpayer Relief Act of 1997 completely revised the tax consequences for the sale of a principal residence. The new rules effectively eliminate any taxation (at least at the federal level) on the gain on the sale of a principal residence for most taxpayers.

Code §121, which replaced the repealed "once in a lifetime" exclusion, begins:

> (a) Exclusion–Gross income shall not include gain from the sale or exchange of property if, during the **five-year period** ending on the date of the sale or exchange, **such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more.**

This new provision has caused uncertainty as to its application in certain situations. We have identified some of these "unusual situations" for clarification.

A. CLARIFICATION OF I.R.C. §121

Many practitioners believe that the only property that qualifies for the exclusion is the **current** principal residence of the taxpayer. The new exclusion is not that limited.

Example. Mark and Sandra Cook bought their principal residence on June 4, 1990. They lived in it until October 15, 1996, when they **converted it to rental property** and acquired a new residence. They sold the former residence on **October 1, 1999.** The five-year period begins on October 2, 1994, and ends on October 1, 1999 (the date of sale).

Mark and Sandra **owned and used** the property as their principal residence for **two years and 13 days** (October 2, 1994, through October 14, 1996) during the five-year period. Therefore, any gain on the sale qualifies for the new exclusion rules. This assumes they did not use the new exclusion rules for the gain on the sale of a **different** residence within the two-year period beginning October 2, 1997, and ending October 1, 1999.

Note. The amount of depreciation claimed after May 6, 1997, is **not** eligible for the exclusion. Assume in the example that the total gain on the October 1, 1999, sale is $45,000 and the depreciation claimed after May 6, 1997, is $2,000.

The $45,000 total gain on the sale is initially reported in Part III of the 1999 Form 4797, **as the property was rental property at the time of sale**. The total gain of $45,000 and the exclusion of $43,000 are shown in Part I of Form 4797 (shown below) according to the Form 4797 instructions. The $2,000 **taxable** portion of the gain is **unrecaptured §1250** gain, which will be included on **line 25, Part IV of the 1999 Schedule D** (enter your unrecaptured §1250 gain, if any, from line 14 of the worksheet on page D-7 of the 1999 Form 1040 instructions).

Form **4797** | Department of the Treasury Internal Revenue Service (99)

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return. ► See separate instructions.

OMB No. 1545-0184 | 1999 | Attachment Sequence No. 27

Name(s) shown on return: *Mark and Sandra Cook* | Identifying number

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1999 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 . . . . | 1 |

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year**

(a) Description of property	**(b)** Date acquired (mo., day, yr.)	**(c)** Date sold (mo., day, yr.)	**(d)** Gross sales price	**(e)** Depreciation allowed or allowable since acquisition	**(f)** Cost or other basis, plus improvements and expense of sale	**(g) GAIN or (LOSS)** Subtract (f) from the sum of (d) and (e)
2 *Section 121 Exclusion*						*(43,000)*

3 Gain, if any, from Form 4684, line 39	3	
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6 Gain, if any, from line 32, from other than casualty or theft	6	*45,000*
7 Combine lines 2 through 6. Enter gain or (loss) here, and on the appropriate line as follows:	7	*2,000*

Partnerships—Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

S corporations—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax.

All others—If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years (see instructions)	8	*0*
9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line(s) as follows (see instructions):	9	*2,000*

S corporations—Enter any gain from line 9 on Schedule D (Form 1120S), line 14, and skip lines 11 and 12 below.

All others—If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.

B. REDUCED EXCLUSION

A taxpayer can claim a reduced exclusion if:

1. The taxpayer **owned a home on August 5, 1997,** sold it before August 5, 1999, and did not meet the two-year ownership and use tests, **or**
2. Due to a change in health or place of employment, the taxpayer **either:**
   - Sold the home before meeting the two-year ownership and use tests, **or**
   - Sold another home within the prior two years and excluded gain on the sale of that home. This applies to sales after May 6, 1997.

> **Practitioner Note.** Due to the uncertainty of the law during 1997, Congress afforded homeowners a transition period to qualify for the liberalized exclusion rules (item 1 above). If the August 5, 1997, ownership requirement is met, the homeowner can sell his or her principal residence without meeting the dual two-year tests, even if he or she fails the qualification for change in health or place of employment. Taxpayers meeting this exception will be afforded the **reduced exclusion** calculation.

Example. Jim Bennett, a single taxpayer, **moved out** of his old personal residence and into a new home on **May 3, 1996**. He had **purchased** the old home on **August 26, 1992.** The former residence was sold on **August 4, 1999**. The **gain** on the sale was **$280,000.** The former home was used as a principal residence for more than three years, **but it did not meet the two-year use test** during the five-year period ending on August 4, 1999 (the date of sale).

Since he **owned the former residence on August 5, 1997**, and sold it during the two-year period beginning August 5, 1997, and ending on August 4, 1999, he is entitled to a **reduced** exclusion.

The worksheet in IRS Publication 523, *Selling Your Home,* is helpful in making this **reduced** exclusion calculation. It is completed for this example and shown below. **The five-year period begins on August 5, 1994, and ends on August 4, 1999, the date of the sale.** During this period, Jim lived in the home for 638 days (from August 5, 1995, through May 3, 1996).

Worksheet 3. **Reduced Exclusion Worksheet**

	Caution: *Complete column (B) only if you are married filing a joint return.*	(A) **You**	(B) **Your Spouse**
1.	Maximum amount	$250,000.00	$250,000.00
2a.	Enter the number of days that you used the property as a main home during the 5-year period ending on the date of sale. (If married filing jointly, fill in columns (A) and (B))	*638*	
b.	Enter the number of days that you owned the property during the 5-year period ending on the date of sale. (If married filing jointly and one spouse owned the property longer than the other spouse, both spouses are treated as owning the property for the longer period)	*1,825*	
c.	Enter the smaller of line 2a or 2b	*638*	
3.	Have you (or your spouse if filing jointly) excluded gain from the sale of another home after May 6, 1997? **NO.** Skip line 3 and enter the number of days from line 2c on line 4. **YES.** If the other home was sold before this home, enter the number of days between the date of sale of the other home and the date of sale of this home. Otherwise, skip line 3 and enter the number of days from line 2c on line 4		
4.	Enter the smaller of line 2c or 3	*638*	
5.	Divide the amount on line 4 by 730 days. Enter the result as a decimal	*.8740*	
6.	Multiply the amount on line 1 by the decimal amount on line 5	*218,500*	
7.	Add the amounts in column (A) and (B) of line 6. This is your reduced maximum exclusion. Enter it here and on Worksheet 2, line 8	*218,500*	

The **reduced exclusion** also applies to the sale of a principal residence due to **"unforeseen circumstances,"** to the extent provided in yet-to-be-announced IRS regulations [I.R.C. §121(c)(2)(B)]. Since there is no IRS guidance in this area, there is no authority to use this provision. Practitioners are cautioned to stay updated on this taxpayer-friendly provision.

C. BUSINESS USE

The exclusion does not apply to any portion of the residence used for business purposes, such as an office in the home, unless that portion used for business meets the two-year "used as a residence" test.

This requirement is very difficult to meet **unless** the taxpayer **stops using** the office portion for business purposes for at least 24 months **prior to the sale** of the residence. It may be advisable for the taxpayer to **intentionally disqualify** the home office by failing the "regular and exclusive use" requirement for several years prior to an anticipated sale of the residence.

D. DEFINITION OF "PRINCIPAL RESIDENCE"

The question of whether a property is a "principal residence" is not easily answered. It depends on the relevant facts and circumstances and the intent of the taxpayer. The term can include a house, condominium, houseboat, mobile home, and stock held by a tenant-shareholder in a cooperative housing corporation. Documentation such as address of record for voting, mail delivery, vehicle registration, state tax return filing status, and the ownership of other homes and their locations are relevant issues to be considered.

For example, consider the northern "snowbirds" who live nine months of the year in Minnesota and three months in Florida. These individuals would have a difficult time claiming that their Florida home was their principal residence. A more difficult decision involves the person(s) who spends **exactly six months** in each of two locations during the year. In this case, **either** residence might qualify, **but not both**.

The following example demonstrates the **exception** to the two-year use test **for individuals with a disability.**

Example. Molly is 75 years old. She ***purchased*** her Arizona retirement home on **August 1, 1997,** and moved into it on **November 1, 1997.** She lived there on a permanent basis through January 10, 1999. Due to Parkinson's disease, Molly was forced to enter a nursing home in her hometown in Michigan on February 1, 1999. If Molly ***sells*** her Arizona home **on or after August 1, 1999,** the gain will qualify for the $250,000 exclusion because she:

1. Became physically (or mentally) unable to care for herself during the five-year period before the sale;
2. Owned and lived in the Arizona home for a total of **at least one year** (from November 1, 1997, through January 10, 1999); and
3. Meets the required two-out-of-five-year **ownership** test.

> **Note.** Under this **exception** to the two-year **use** test, a taxpayer is considered to live in his or her home during any time the home is owned and the taxpayer lives in a state-licensed nursing home.

E. HOME DESTROYED OR CONDEMNED

If a home is destroyed or condemned, any gain (for example, because of insurance proceeds received) qualifies for the exclusion. Any part of the gain that cannot be excluded under I.R.C. §121 (because it is more than the limit) may still be postponed under I.R.C. §1033 (involuntary conversions).

4. THE HOME OFFICE DEDUCTION

Beginning in 1999, I.R.C. §280A(c)(1) allows a home office to qualify as a principal place of business if:

1. It is used exclusively and regularly for **administrative** or **management** activities of any trade or business of the taxpayer, **and**
2. There is no other fixed location where the taxpayer conducts **substantial** administrative or management activities of that trade or business.

Question 1. What constitutes administrative or management activities?

Answer 1. These activities include:

- Billing customers, clients, or patients
- Keeping books and records
- Ordering supplies
- Setting up appointments
- Forwarding orders or writing reports

Question 2. I have a client who is a self-employed decorator. He has a cell phone in his truck that he uses extensively to set appointments and order supplies. Will he be entitled to deduct home office expenses on his 1999 Schedule C?

Answer 2. Yes, assuming that the home office meets the two requirements shown at the beginning of this problem. The fact that your client conducts administrative and/or management duties from his truck will not disqualify the home office expenses.

In IRS Publication 587 (for use in preparing 1998) returns), *Business Use of Your Home,* the IRS explains that the following activities will **not** disqualify a taxpayer's home office as the **principal place of business:**

- The taxpayer conducts administrative or management duties at places that are **not fixed locations** of the business, such as in a vehicle or hotel room.
- The taxpayer has suitable space to conduct administrative activities outside the home but **chooses** to use the home office for those activities instead.
- The taxpayer conducts substantial **nonadministrative or nonmanagement** business activities at a fixed location outside the home office.
- The taxpayer **occasionally** conducts **minimal** administrative or management activities at a fixed location outside the home office.
- The taxpayer has **others** conduct administrative or management activities at locations other than the home office. (**Example:** Another company performs the billing and bookkeeping from its place of business.)

Question 3. It appears that most self-employed taxpayers will be entitled to deduct office-in-home expenses on their 1999 Schedule C. But what about employees? Are the rules different for them in 1999?

Answer 3. Yes. IRS Publication 587 gives four examples. **Three** of the examples involve **self-employed** taxpayers: a plumber, a sales representative, and an anesthesiologist (factual situation of Dr. Soliman). **In all three examples, the self-employed taxpayers were entitled to deduct 1999 home office expenses.**

IRS Publication 587 gives a fourth example of an **employed teacher**. The teacher **is not** entitled to a 1999 home office deduction. That example is shown next.

Example. Kathleen is employed as a teacher. She is required to teach and meet with students at the school and to grade papers and tests. The school provides her with a small office where she can work on her lesson plans, grade papers and tests, and meet with parents and students. The school does not require her to work at home.

Kathleen prefers to use her home office and does not use the one provided by the school. She uses the home office exclusively and regularly for the administrative duties of her job.

In **1998** Kathleen's home office did not qualify as her principal place of business because the administrative activities were less important than her actual teaching duties at the school. Because her home office was **not** her principal place of business in 1998, it was not necessary to determine whether she maintained it for the **convenience of her employer**.

In 1999 Kathleen will still have to meet the convenience-of-employer test. Because her employer provides her with an office and does not require her to work at home, **she does not meet the convenience-of-employer test.** Consequently, she is **not** entitled to deduct any home office expenses on her 1999 tax return.

Answer 3 Conclusion. Most **employees** will find it impossible to deduct any 1999 home office expenses due to the restrictive convenience-of-employer requirement imposed by I.R.C. §280A(c).

Question 4. I have many self-employed taxpayers who will qualify for home office deductions in 1999. I am concerned with gain on the office portion when the home is sold after 1999. Under the new rules for sales of residences, any gain on the home sale is not excludable to the extent of depreciation taken after May 6, 1997, on the office portion. Are there any solutions to this potential tax trap that will arise when the home is sold?

Answer 4. Several observations might help. Assume that MACRS was used for the office portion of the home that is sold after 1999.

Observations

1. A $500 office-in-home deduction on a self-employed taxpayer's 1999 Schedule C could save approximately $135 of income and self-employment tax, assuming a 15% income tax bracket. If the taxpayer is in a higher income tax bracket, the tax savings are even greater.
2. Office-in-home deductions will reduce self-employment tax, but the resulting gain on the sale of the office portion escapes S-E tax.

Note. Example A and observations 3 through 5, which follow, assume that the taxpayer did not use **100%** of the home as a principal residence for at least two years in the five year period ending on the date of the sale. The result is that there are **two** sales: (1) sale of a principal residence and (2) sale of business property. The gain on the former can be excluded. The gain on the latter cannot.

Example A Facts. The home office portion of the home was used as an office and **not** as a residence for **more** than two years in the five-year period ending on the date of sale. The residence is sold August 10, 2003, and **10%** of the home has been used as a home office from January 1, 1999, through December 31, 2001.

Observations

3. The gain on the sale of the **office portion** (which is due at least partially to prior MACRS deductions) will probably be a combination of §1231 gain and unrecaptured §1250 gain.
4. The §1231 portion of the gain on the sale of the gain on the office portion will be taxed at either a **20%** (**18% for sales after 2005** if a more-than-five-year holding period test is met) or a **10%** (**8% for sales after 2000** if a more-than-five-year holding period test is met) rate, depending on the taxable income in the year of sale.
5. The unrecaptured §1250 portion of the gain on the office portion sale is included on line 25 in Part IV of Schedule D. This gain will ordinarily be taxed at a **25% (maximum) rate**.

Note. Example B and observation 6, which follows, assumes that the taxpayer **did use 100%** of the home as a principal residence for at least two years during the five-year period ending on the date of the sale.

Example B Facts. The residence is sold August 10, 2003. An office in the home was used exclusively and regularly for administrative and/or management activities of the taxpayer's business from January 1, 1999, through December 31, 2000.

In 2001, the taxpayer deliberately took action that caused the home office to fail the exclusive-use test. Because of this action, home office deductions were not claimed on the taxpayer's 2001, 2002, and 2003 Schedules C.

Observation

6. The tax result in Example B is that the gain on the sale of the home in 2003 is **excludable** due to I.R.C. §121(a). However, I.R.C. §121(d)(6) provides an exception to the extent that the portion of the total gain on the sale is due to **depreciation taken after May 6, 1997.**

Assume the following additional facts for Example B above.

- The **total** gain on the August 10, 2003, sale of the home is $39,000.
- Of that $39,000 total gain, $815 was due to the 1999 and 2000 MACRS deductions.

Tax result for 2003. $38,185 of the $39,000 gain will be excludable under I.R.C. §121(a). The remaining gain of $815 is taxable. It is unrecaptured §1250 gain and will be included on line 25 in Part IV of Schedule D. (See the partially completed Worksheet 2 from the 1999 version of IRS Publication 523, *Selling Your Home,* below. Note the instructions on line 11 of the worksheet.

Publication 523 ***(For use in preparing 1999 returns)***

Form 1040
Use this worksheet to compute the gain on the sale of a home, the allowable exclusion, and the taxable amount, if any.

Worksheet 2. **Gain (or Loss), Exclusion, and Taxable Gain**

Part 1–Gain (or Loss) on Sale		
1.	Selling price of home	
2.	Selling expenses	
3.	Subtract line 2 from line 1	
4.	Adjusted basis of home sold. (From Worksheet 1, line 15.)	
5.	Subtract line 4 from line 3. This is the **gain** (**or loss**) on the sale. If this is a loss, stop here	*39,000*
Part 2–Exclusion and Taxable Gain		
6.	Enter any depreciation claimed on the property for periods after May 6, 1997. If none, enter zero	*815*
7.	Subtract line 6 from line 5. (If the result is less than zero, enter zero.)	*38,185*
8.	Maximum exclusion. (See *Amount of Exclusion* in this chapter.) ***(assume joint return)***	*500,000*
9.	Enter the smaller of line 7 or line 8. This is your exclusion. If you are reporting the sale on the installment method, enter this amount on line 15 of Form 6252	*38,185*
10.	Subtract line 9 from line 5. This is your taxable gain. Report it on Schedule D (Form 1040) as described under *Reporting the Gain* on page 15. If the amount on this line is zero, do not report the sale or exclusion on your tax return. **If the amount on line 6 of this worksheet is more than zero, complete line 11**	*815*
11.	Enter the smaller of line 6 or line 10. Enter this amount on line 11 of the *Unrecaptured Section 1250 Gain Worksheet* in the instructions for Schedule D (Form 1040)	*815*

5. ROTH IRAS AND CONVERSION OF IRAS TO ROTH IRAS

Final regulations were issued in early 1999 that provided answers to the many unanswered questions that arose in 1998. They retained the general substance of proposed regulations issued in October 1998, clarified problem areas, and closed several loopholes (Treas. Reg. §1.408A-1 through A-9, February 3, 1999 – T.D. 8816).

A. CONTRIBUTIONS

DEFINITION OF COMPENSATION FOR ROTH IRA CONTRIBUTION PURPOSES

Compensation is the **same** as under traditional IRA rules. The **spousal rules** for traditional IRAs also apply to Roth IRAs. These rules permit a taxpayer to treat the spouse's higher earned income as his or her own for Roth IRA contribution purposes. However, this special rule applies only to the extent that the spouse's earned income is **not:**

- Used by the spouse for his or her Roth IRA contribution purposes, or
- Used by the spouse for his or her traditional IRA contribution purposes.

Note. See page 706 in the 1998 *Income Tax Workbook* for Q&A 4 of Prop. Reg. 1.408A-3, which was adopted by the final regulations.

EXCESS ROTH IRA CONTRIBUTIONS (TREAS. REG. §1.408A-3, Q&A 3, 7)

If an individual makes **both** Roth IRA and traditional IRA contributions in the **same** tax year, the limitation for the Roth IRA contribution is the **lesser of**

1. $2,000 **reduced** by the amount contributed to the individual's traditional IRA, **or**
2. The limitation imposed by the modified AGI phase-out rules

Example. In 1999 Joan, a single individual, has modified AGI of $40,000 and compensation (wages) of $5,000. For 1999 she can contribute a maximum of $2,000 to a traditional IRA, a Roth IRA, or a combination of traditional and Roth IRAs. She contributes $2,000 to **each** type of IRA for 1999.

The $2,000 Roth IRA contribution is an **excess contribution** for 1999 because contributions are applied **first** to her traditional IRA, **then** to her Roth IRA. Therefore, her $2,000 Roth IRA contribution is subject to the **6% penalty tax.** However, the penalty will **not** apply if the $2,000 excess Roth IRA contribution plus earnings are **withdrawn before the due date (including extensions)** for her 1999 return. If that is done, the earnings on the $2,000 are taxable on Joan's 1999 return.

Note. If Joan does **not** withdraw the excess $2,000 plus earnings by the due date (including extensions), the aggregate excess contributions are treated as **deemed** Roth IRA contributions for subsequent years. This theory applies to the extent that Joan is eligible to make future Roth IRA contributions but does not actually do so.

B. ROLLOVERS AND CONVERSIONS

CONVERSION OF A SEP IRA OR A SIMPLE IRA

One of the most interesting situations in 1998 was the contribution to a SEP IRA or SIMPLE IRA (usually a larger contribution than to a Roth or traditional IRA) **followed by a conversion** to a Roth IRA. This resulted in a larger Roth IRA, especially if it could be done every year. The final regulations provide that once an amount in a SEP or SIMPLE IRA has been converted to a Roth IRA, future contributions under the SEP or SIMPLE IRA plan may **not** be made to the Roth IRA (Treas. Reg. §1.408A-4, Q&A 4).

FOUR-YEAR SPREAD ISSUES

1. Taxpayers who converted traditional IRAs to Roth IRAs in 1998 benefited by the four-year income spread, unless they elected to include the entire amount in income in 1998. For 1999 and later years' conversions, the four-year spread is not available. Some taxpayers and financial planners thought that they could elect to convert only the **basis resulting from nondeductible contributions** of a traditional IRA to a Roth IRA, resulting in no tax consequence for the conversion. That strategy is not permitted. The regulations clarify that any converted amount from a traditional IRA is treated as a distribution from the traditional IRA (Treas. Reg. §1.408A-4, Q&A 1).
2. If a taxpayer uses the four-year spread for a **1998 conversion,** special rules apply to distributions from the resulting Roth IRA within the four-year period. These rules prevent taxpayers who benefit from the four-year spread from accessing funds from the Roth IRA with little or no

tax consequence. Income inclusion is **accelerated** for any distribution received **before 2001,** the fourth year of the spread. A taxpayer who withdraws converted amounts prior to 2001 will be required to include in income the amount otherwise includable under the four-year rule, **plus the lesser of:**

- The taxable amount of the pre-2001 distribution, or
- The remaining taxable amount of the conversion (not included in current or prior years).

In subsequent years, assuming no additional distributions, the amount includable in income will be the lesser of:

- The amount otherwise required under the four-year rule, or
- The remaining taxable amount of the conversion (Treas. Reg. §1.408A-6, Q&A 6).

Example. In 1998 John, who is 52, converted $80,000 from a traditional IRA to a Roth IRA. John had a basis of $20,000 in the IRA, resulting in taxable income of $60,000 to be spread over the four-year period. In 1998, $15,000 was properly reported on his return.

In 1999 John withdrew $8,000 from the Roth IRA to pay for his daughter's wedding. Since John's distribution was received prior to 2001, he will recognize the following 1999 income:

Regular amount of the four-year spread	$15,000
Amount of the 1999 distribution	8,000
Total taxble amount in 1999	**$23,000**

Observation. John would also be subject to the 10% early withdrawal penalty of $800 due to his age.

In 2000, assuming no other distributions are taken, the full $15,000 of the third-year spread amount is includable in income. In 2001, only $7,000 of the remaining four-year spread amount is taxable.

Summary of John's Recognized Income during the Four-Year Spread Period (1998–2001)

Year	Four-Year Spread Amount	Accelerated Amount	Total
1998	$15,000	N/A	$15,000
1999	15,000	$8,000	23,000
2000	15,000	N/A	15,000
2001	7,000	N/A	7,000
Total taxable income			**$60,000**

3. If a Roth IRA owner **dies** during the four-year spread period. The remaining amount of untaxed spread income is includable on the **decedent's final Form 1040.** However, if a **surviving spouse** is the sole beneficiary of all of the decedent's Roth IRAs, he/she can elect to continue the four-year spread (Treas. Reg. §1.408A-4, Q&A 11).

Note. The **acceleration rule** explained above also applies to the surviving spouse for the duration of the four-year period.

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C. RECHARACTERIZATIONS

Recharacterizations were frequent in 1998, due mainly to the stock market downturn in late summer. The obvious reason for a recharacterization of a Roth IRA is to reduce the tax consequence of the conversion because of the declining value within the Roth IRA. During 1998, taxpayers were making repeated recharacterizations as they saw their portfolios decrease in value.

The IRS has changed the rules on recharacterizations several times. The current rules are governed by IRS Announcement 99-57, issued in May 1999, and Notice 98-50, issued in October 1998. These current rules are summarized below:

1. Taxpayers who **timely filed** their 1998 returns can elect to recharacterize a 1998 traditional or Roth IRA contribution by taking "corrective action" on or before **October 15, 1999.** This is allowed even if the taxpayer did **not** request extensions on Form 4868 or 2688.
2. An IRA owner who converts a traditional IRA to a Roth IRA **in 1998** and then transfers (recharacterizes) it back to a traditional IRA may **reconvert** it to a Roth IRA only **once** during 1999. This rule applies **without regard** to whether the initial conversion occurred before, on, or after November 1, 1998.
3. Recharacterizations must be made via a "trustee-to-trustee" transfer that is completed no later than October 15, 1999.
4. Amended 1998 returns may be required due to recharacterizations.
5. A recharacterization may result in loss of the four-year income spread.
6. Parts II and III of Form 8606 (Nondeductible IRAs) are used to report recharacterizations.
7. **Beginning in 2000, the recharacterization rules are more stringent.** If an IRA owner converts a traditional IRA to a Roth IRA and then reconverts the Roth IRA back to a traditional IRA, a reconversion to a Roth IRA may not occur before the **later** of:
   - The beginning of the tax year following the tax year in which the amount was converted to a Roth IRA, or
   - The end of the 30-day period beginning on the day on which the IRA owner transfers (recharacterizes) the amount from the Roth IRA back to the traditional IRA.

If a year 2000 or later reconversion is made **before** the later of the two above dates, the reconversion will be treated as a **failed conversion.** The failed conversion will be subject to correction via a recharacterization to a traditional IRA.

Examples 1 and 2 below explain the current rules for 1998 and 1999 recharacterizations.

Example 1. Scott, a single individual, converted his traditional IRA to a Roth IRA on December 15, 1998. He used the four-year income spread. His 1998 taxable income was $98,000, including his taxable conversion amount of $4,000 (25% of the taxable conversion amount of $16,000).

In September 1999 he realized that all of his 1999 income will be taxed at 15% due to a much smaller profit from his business. He **recharacterized** (reconverted) the 1998 conversion amount to his traditional IRA on September 14, 1999. Two days later, on September 16, 1999, he **recharacterized** (reconverted) the traditional IRA amount to his Roth IRA.

Scott's tax consequences from his 1999 recharacterizations are:

1. He will lose the four-year income spread, as it applies only to 1998 conversions.
2. He must file an amended 1998 Form 1040X to remove the $4,000 four-year spread amount from his AGI. As a result, Scott will be entitled to a refund of $1,240 (31% × $4,000) plus interest.
3. The entire taxable 1999 conversion amount will be included in his 1999 AGI.

Example 2. Nicole, a 60-year-old single individual, made a $2,000 Roth IRA contribution in 1998. Her 1998 net profit from her part-time hair-styling business was $12,000. She expects to have little retirement income other than social security. She **timely filed** her 1998 tax return.

Nicole **recharacterized** her 1998 Roth IRA contribution as a traditional IRA contribution on October 12, 1999.

Nicole's tax consequences from her 1999 recharacterization are:

1. She must file a 1998 amended Form 1040X to deduct the $2,000 traditional IRA contribution.
2. Future distributions from her traditional IRA will probably be tax-free due to her small future retirement income.

D. DISTRIBUTIONS

QUALIFIED DISTRIBUTIONS

As a quick review, the only four distributions that qualify for tax-free treatment from a Roth IRA are those:

1. Made on or after the date on which the owner attains the age of 59½,
2. Made to a beneficiary or to the estate of the owner following the owner's death,
3. Attributable to the owner's disability, or
4. Used to pay for qualified first-time homebuyer expenses.

Practitioner Note. Distributions received for college tuition payments are not qualified distributions from a Roth IRA. This type of distribution is **not** subject to the 10% penalty; however, any part of it attributable to earnings is subject to income tax.

Even if one of the four requirements above is met, a Roth IRA distribution is **not** a qualified (tax-free) distribution if it is made during the initial five-taxable-year period, as explained in the following example.

Example. Sammy, age 62 in 1999, makes the following contributions to his Roth IRA:

Tax Year	Amount of Roth IRA Contribution	Date of Contribution
1998	$2,000	April 14, 1999
1999	2,000	May 1, 1999
2000	2,000	April 14, 2001
2001	2,000	April 15, 2002
2002	2,000	June 3, 2002

Due to his wife's large unreimbursed medical expenses, Sammy receives a total $19,000 distribution from his Roth IRA on **November 10, 2002.** Therefore, $9,000 (the portion attributable to earnings) of the $19,000 total distribution will be taxable on the joint 2002 return.

Sammy's five-year period begins on **January 1, 1998,** the first day of the first tax year for which Sammy made a Roth IRA contribution. His five-year period will end on **December 31, 2002.** If Sammy waits until **January 1, 2003** to receive the distribution, the entire $19,000 will be a qualified Roth IRA distribution and thus will be tax-free.

Observations concerning the five-taxable-year period rule for qualified distributions:

1. The 5-year period does not start over for a beneficiary of a deceased Roth IRA owner.
2. If a total distribution is received by a Roth IRA owner and another Roth IRA is established later, the five-year period does not start over.
3. The five-year period begins on the first day of the first tax year for which the first Roth IRA contribution was made for an individual. The first Roth IRA contribution can be **either** an annual contribution or a qualified rollover contribution.

ORDERING RULES FOR ROTH IRA DISTRIBUTIONS

Any amount distributed from an individual's Roth IRA is treated as made in the following order:

1. From nondeductible regular (annual) contributions
2. From initial conversion (taxable portion first)
3. From later conversions (taxable portion first)
4. From earnings

Practitioner Note

1. The ordering rules do **not** apply to 1998 converted amounts for which the four-year spread is used if distributions are received prior to 2001. (See the prior example in section B explaining the special **acceleration rule** that applies in this situation.)
2. All Roth IRAs of an individual are combined and considered as a single Roth IRA for ordering purposes.

Example. Linda, age 56 in 2003, withdraws $20,000 from her Roth IRA on June 5, 2003. The total account balance at that time is $24,000. The $24,000 balance consists of:

Type of Contribution	Date of Contribution	Amount of Contribution
Annual contribution for 1998	April 12, 1999	$2,000
Annual contribution for 1999	May 10, 1999	2,000
Conversion of traditional IRA	December 30, 1998	8,000*
Conversion of traditional IRA	March 20, 2001	7,000**

Note. The entire $8,000 conversion amount was taxable. She used the four-year spread in 1998–2001.
Note. The entire $7,000 conversion amount was taxable on her 2001 return.

Total contributions to the Roth IRA	**$19,000**
Plus earnings	**5,000**
Account balance as of June 5, 2003	**$24,000**

Linda's 2003 tax consequences as a result of the $20,000 distribution are as follows:

1. $1,000 of the distribution is taxable. The following amounts constitute the $19,000 tax-free portion of the $20,000 distribution and are applied in the order shown:

Annual contributions for 1998 and 1999	$ 4,000
The 1998 conversion previously taxed	8,000
The 2001 conversion previously taxed	7,000
Tax-free portion of the distribution	**$19,000**

The remaining $1,000 of the $20,000 distribution is attributable to the $5,000 **earnings** amount and is **taxable**.

2. Since Linda is under age 59½ and does not qualify for any of the exceptions to the 10% penalty, she is **liable for a $800 penalty,** computed as follows:

$1,000 taxable portion of distribution × 10%	$100
$7,000 (the 2001 conversion amount) × 10%	700
Total amount of the 20% penalty	**$800**

Linda is liable for the penalty on the 2001 conversion as the $20,000 distribution was made **within the five-taxable-year period beginning with January 1, 2001,** the first day of the year in which the $7,000 conversion contribution was made [Treas. Reg. §1.408A-6, Q&A 5].

Note. The 5-taxable-year period for the 10% penalty applied to a conversion contribution **is determined separately for each conversion contribution.** The 5-year period(s) for conversion contribution(s) **need not be the same** as the 5-taxable-year period for determining whether a Roth IRA distribution is a qualifying distribution. [Reg. §1.408A-6, Answer #5(c)]

E. OTHER ROTH IRA ISSUES

1. A minor child may own a Roth IRA.
2. Contributions to an Educational IRA have no effect on the eligibility to contribute to either a traditional IRA or a Roth IRA.
3. The four-year income spread may be used for qualified conversion contributions made in 1999 **if the distribution from the traditional IRA was made in 1998.** The four-year spread begins with the 1998 return for the year the distribution was received.

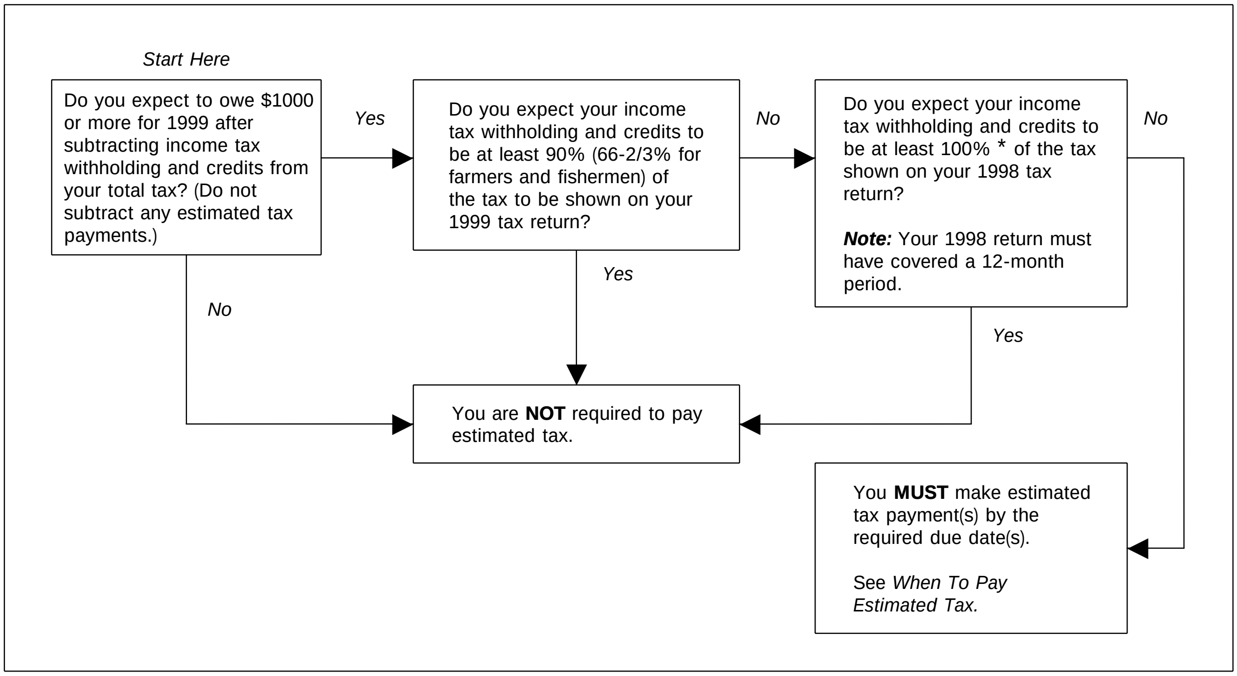
6. ESTIMATED TAX PROVISIONS: INDIVIDUALS

Taxpayers and practitioners have been confused by the frequent changes in the estimated tax provisions. The notable changes made by recent tax legislation are:

1. The threshold requirement to avoid the estimated tax penalty for tax years beginning **after 1997** was increased from $500 to $1,000.
2. The **safe harbor for high-income (AGI in excess of $150,000) taxpayers** has been modified three times. The most recent modification was mandated by the Tax and Trade Relief Extension Act of 1998, which was enacted in October 1998.

See the following flow chart for **1999** estimated tax payments (IRS Publication 505, Tax Withholding and Estimated Tax).

Figure B. **Do You Have To Pay Estimated Tax?**



* 105% if less than two-thirds of your gross income for 1998 and 1999 is from farming or fishing and your 1998 adjusted gross income was more than $150,000 ($75,000 if your filing status for 1999 is married filing a separate return).

The current safe harbor percentages for high-income taxpayers are as follows:

- For estimated tax payments due for the tax year **1998,** the safe harbor percentage is **100% of 1997 tax liability.**
- For estimated tax payments due for the tax year **1999,** the safe harbor percentage is **105% of 1998 tax liability.**
- For estimated tax payments due for the tax year **2000 or 2001,** the safe harbor percentage is **106% of 1999 or 2000 tax liability,** respectively.
- For estimated tax payments due for the tax year **2002,** the safe harbor percentage is **112% of 2001 tax liability.**
- For estimated tax payments due for tax year **2003 and later years,** the safe harbor percentage is **110% of the preceding year's tax liability.**

See the Taxpayer Penalties problem in the Individual and Small Business Problems chapter for extensive coverage of the estimated tax penalty.

7. INNOCENT SPOUSE RULES

Innocent spouse relief was initially granted in 1971 by I.R.C. §6013(e). Expanded relief was offered by new I.R.C. §6015 as part of the IRS Restructuring and Reform Act of 1998. The new I.R.C. §6015 replaces I.R.C. §6013(e) for tax liabilities arising after **July 22, 1998,** and tax liabilities arising on or before that date that remain unpaid as of that date.

Many married taxpayers choose to file a joint tax return. Both taxpayers are jointly and individually responsible for the tax and any interest or penalties due on the joint return even if they later divorce. This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. One spouse may be held responsible for all the tax due even if all the income was earned by the other spouse.

Under new I.R.C. §6015, a spouse will be relieved of the tax, interest, and penalties on a joint return. Three types of relief are available:

1. **Innocent spouse relief** (similar to old rules but expanded and liberalized)
2. **Separation of liability** (new provision not contained in old law)
3. **Equitable relief** (new provision not contained in old law)

COMPARISONS OF OLD LAW (I.R.C. §6013(E)) TO NEW LAW (I.R.C. §6015)

1. Under **old** law, the innocent spouse must have filed a joint return that had an understatement of tax due to grossly erroneous items of the other spouse.

   Under **new** law, the items attributable to the other spouse need to be only erroneous.
2. Under **old** law, partial relief for a portion of the understatement of tax was not sanctioned.

   Under **new** law, partial relief is granted if, at the time the innocent spouse filed the joint return, he or she knew or had reason to know that there was an understatement of tax due to the other spouse's erroneous items. However, the innocent spouse did not know how large the understatement of tax was.
3. Under **old** law, there was no time limit for requesting innocent spouse relief.

   Under **new** law, Form 8857 (Request for Innocent Spouse Relief) must be filed no later than two years after the date on which the IRS first attempted to collect the tax from the innocent spouse (such as by levy or seizure action) after July 22, 1998.
4. Under **old** law, the innocent spouse could qualify for relief only if the understatement of tax on the joint return exceeded a specified percentage of the innocent spouse's adjusted gross income.

   Under **new** law, this restriction has been eliminated.
5. Under **old** law, innocent spouse relief was available only if the understatement of tax on the joint return exceeded $500.

   Under **new** law, this restriction has been eliminated.

Table 1. **Three Types of Relief at a Glance** ***(under new law)***

Factors	Rules for Innocent Spouse Relief	Rules for Separation of Liability	Rules for Equitable Relief
Type of Liability	You must have filed a joint return that has an understatement of tax due to an erroneous item of your spouse.	You must have filed a joint return that has an understatement of tax due, in part, to an item of your spouse.	You must have filed a return that has either an understatement or an underpayment of tax.
Marital Status		You must be no longer married, legally separated, or have not lived with your spouse in the same house for an entire year before you file for relief.	
Knowledge	You must establish that at the time you signed the joint return you did not know, and had no reason to know, that there was an understatement of tax.	If IRS establishes that you actually knew of the item giving rise to the understatement, then you are not entitled to make the election to the extent of the actual knowledge.	
Other Qualifications			You do not qualify for innocent spouse relief or separation of liability.
Unfairness	It must be unfair to hold you liable for the understatement of tax taking into account all the facts and circumstances.		It must be unfair to hold you liable for the underpayment or understatement of tax taking into account all the facts and circumstances.
Refunds	Yes, your request can generate a refund.	No, your request cannot generate a refund.	Yes, for amounts paid between July 22, 1998, and April 15, 1999, and for amounts paid pursuant to an installment agreement after the date the request for relief is made.

IRS SPOUSAL NOTIFICATION (NOTICE TO OTHER JOINT FILER)

The IRS is required to inform the other spouse (or former spouse) who filed the joint return if innocent spouse relief or separation of liability relief has been requested. The other spouse (or former spouse) is allowed to participate in the determination of the amount of tax relief granted to the innocent spouse.

INNOCENT SPOUSE RELIEF

By requesting innocent spouse relief, a taxpayer can be relieved of responsibility for paying tax, interest, and penalties for the misdeeds of the other spouse who filed the joint return. If the IRS approves this request from the innocent spouse, IRS collection of tax, interest, and penalties can be obtained only from the other spouse for the amount of relief approved. However, the innocent spouse remains jointly and individually responsible for any tax, interest, and penalties that do not qualify for relief. The IRS can collect these amounts from either spouse.

The following **three** conditions must be met in order to qualify for **innocent spouse relief.**

1. A spouse filed a joint return that has an **understatement of tax** due to **erroneous items** of the other spouse.
2. A spouse establishes that at the time the joint return was signed, he or she **did not know, and had no reason to know,** that there was an understatement of tax.
3. Taking into account all the facts and circumstances, it would be **unfair** to hold the spouse liable for the understatement of tax.

ERRONEOUS ITEMS

Erroneous items are **either** of the following:

- **Unreported income.** This is any gross income item received by the other spouse that is not reported on the joint return.
- **Incorrect deduction, credit, or basis.** This is any improper deduction, credit, or property basis claimed by the other spouse on the joint return.

Examples of Erroneous Items

- The expense for which the deduction was taken was never made. **Example.** The other spouse deducted $10,000 of legal expenses on the Schedule C business owned and operated by the other spouse, but nothing was paid during the tax year in question.
- The expense does not qualify as a deductible expense. **Example.** The other spouse claimed a Schedule C deduction for overweight and speeding fines paid for a trucking business. These fines are not deductible.
- The other spouse omitted $45,000 of grain receipts on the Schedule F farming business owned and operated by the other spouse.

UNDERSTATEMENT OF TAX

An understatement of tax is generally the difference between the total amount of tax that should have been shown on the joint return and amount of tax that was actually shown on the return.

Note. The IRS will figure the understatement of tax due to erroneous items of the other spouse after the innocent spouse files Form 8857. But, the innocent spouse can make this computation by completing Worksheet 1 found in IRS Publication 971 (Rev. December 1998), *Innocent Spouse Relief.*

Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**
(***Note.*** *This worksheet is optional. Keep it for your records. Do not mail it to the IRS.)*

1. Enter your total tax including all changed items. 1. ______

   Note. *This should be shown on the IRS notice or audit report.*

2. Refigure your total tax by including all items except your spouse's erroneous items. Include items you knew about or had reason to know about. .... 2. ______
3. **Tax eligible for innocent spouse relief.** Subtract line 2 from line 1. .... 3. ______

Example. Adam and Victoria White filed a joint 1996 tax return (Form 1040) in 1997. The total tax shown on the return was $2,734. In 1998 the IRS audited their return. The examiner found that Victoria failed to report $2,500 of unemployment compensation and $5,000 from a taxable IRA distribution. On August 10, 1998, the IRS mailed the Whites a Notice of Deficiency that showed additional tax of $1,125 plus $390 of interest and penalties.

At the time Adam signed the 1996 joint return, he knew about Victoria's unemployment compensation. **However, he did not know about, and had no reason to know about, the $5,000 IRA distribution.** Adam thinks it would be **unfair** for the IRS to hold him responsible for the understatement of tax due to Victoria's omission of the $5,000 IRA distribution. Adam did not benefit from the $5,000, as Victoria spent the money on a Las Vegas vacation she took with a co-worker.

Adam uses Worksheet 1 to figure the tax that qualifies for innocent spouse relief. He completes Worksheet 1 as follows:

Line 1. Adam enters $3,859. This is the total tax on the joint 1996 tax return as shown by the IRS Notice of Deficiency (exam report).

Line 2. $3,109 is what the total tax would have been if it included **only the amount of Victoria's unreported income that Adam was aware of.** Adam calculated the $3,109 as follows:

Taxable income shown on the joint return	$ 18,200
Plus: Victoria's unreported unemployment compensation	2,500
Total	$ 20,700
Tax on $20,700 from 1996 Tax Table	**$ 3,109**

Note. The Whites did not claim any tax credits and were not liable for other taxes such as self-employment tax in 1996. Therefore, $3,109 is the total tax for purposes of line 2 on Worksheet 1.

Line 3. Adam subtracts line 2 from line 1. This is the understatement of tax due to Victoria's IRA distribution that **he did not know about, and had no reason to know about.** This $750 is the amount of tax eligible for Adam's **innocent spouse relief.**

COMPLETED WORKSHEET 1 FOR ADAM

Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**
(***Note.*** *This worksheet is optional. Keep it for your records. Do not mail it to the IRS.)*

1. Enter your total tax including all changed items. 1. ***$3,859***

   Note. *This should be shown on the IRS notice or audit report.*

2. Refigure your total tax by including all items except your spouse's erroneous items. Include items you knew about or had reason to know about. 2. ***$3,109***

3. **Tax eligible for innocent spouse relief.** Subtract line 2 from line 1. .... 3. ***$750***

Although Adam and Victoria were not divorced or separated at the time they received the 1996 Form 1040 IRS exam report in August of 1998, Adam was considering filing for divorce. Therefore, Adam checked the box for line 4 on the completed Form 8856 and requested **innocent spouse relief**. Adam could not check the box for line 3 on Form 8857 to request **separation of liability relief.**

See the Form 8857 that Adam prepared in August 1998 in response to the IRS exam report.

Form **8857** (Rev. December 1998)
Department of the Treasury Internal Revenue Service

Request for Innocent Spouse Relief

(And Separation of Liability and Equitable Relief)

▶ **Do not file with your tax return.** ▶ **See instructions.**

OMB No. 1545-1596

Your name: *Adam L. White*	**Your social security number**: *222 22 2222*
Your current address: *13 Skull Rapids Lane*	Apt. no.
City, town or post office, state, and ZIP code. If a foreign address, see instructions.: *Cisco, UT 84515*	Daytime phone no. (optional) ( )

Before you begin, you need to understand the following terms. See instructions for descriptions.

- Separation of Liability
- Joint and Several Liability
- Innocent Spouse Relief
- Understatement of Tax
- Equitable Relief
- Underpayment of Tax

TIP *The IRS can help you with your request. If you are working with an IRS employee, you can ask that employee, or you can call 1-800-829-1040.*

1 Enter the year(s) for which you are requesting relief from liability of tax (see instructions) . ▶ *1996*

2 Information about your spouse (or former spouse) to whom you were married at the end of the year(s) on line 1.

Name: *Victoria L. White*	**Social security number**: *777 77 7777*
Current home address (number and street). If a P.O. box, see instructions.: *13 Skull Rapids Lane*	Apt. no.
City, town or post office, state, and ZIP code. If a foreign address, see instructions.: *Cisco, UT 84515*	Daytime phone no. (if known) ( )

TIP *If you only have an **underpayment of tax** (tax shown on your joint return that was not paid), you may only request **equitable relief.** Skip lines 3 and 4 and see line 5 and its instructions.*

3 If you have an **understatement of tax,** you may request **Separation of Liability.** You may be relieved of liability for your spouse's (or former spouse's) part of the liability. However, this relief is available only if you and your spouse (or former spouse):

- Are no longer married, or
- Are legally separated, or
- Have lived apart at all times during the 12-month period prior to the date you file this form.

If one of the above conditions apply, attach a statement as explained on page 3 and check here . . . ▶ ☐

4 If you have an **understatement of tax** due to erroneous items of your spouse (or former spouse), you may be allowed **Innocent Spouse Relief.** Attach a statement as explained on page 4 and check here . . . . . . ▶ ☒

5 If you have an **underpayment of tax** or you do not qualify for relief under **3** or **4** above, we will automatically consider whether you qualify for **Equitable Relief.** Attach a statement as explained on page 4 and check here . . . . ▶ ☐

Where To File: Generally, send this form to: **Internal Revenue Service Center, Cincinnati, OH 45999-0857.** But if you are meeting with an IRS employee or you received an IRS notice of deficiency, see page 2.

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

Sign Here Keep a copy of this form for your records.	Your signature: *Adam L. White*			Date: *Aug. 15, 1998*
Paid Preparer's Use Only	Preparer's signature	Date	Check if self-employed ☐	Preparer's social security no.
	Firm's name (or yours if self-employed) and address			EIN
				ZIP code

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 24647V Form **8857** (Rev. 12-98)

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Statement Explaining Why I Am Requesting Innocent Spouse Relief

I filed a joint 1996 income tax return with my wife, Victoria L. White. Her SSN is 777-77-7777. Our joint 1996 tax return was examined by the Moab, Utah, IRS office. We received the IRS exam report on August 12, 1998. I have attached a copy of the 1996 IRS exam report to Form 8857. There were two adjustments proposed in the exam report. Both relate to unreported income of my wife, Victoria. On our joint 1996 tax return, we failed to report the following income:

1. $2,500 of unemployment compensation received by Victoria
2. $5,000 of a taxable IRA distribution received by Victoria

I was aware of the unemployment compensation, as Victoria received a bi-weekly check. I was not aware of the IRA distribution she received. I was not even aware that she had an IRA, as she contributed to it prior to our marriage in May 1995.

She used the $5,000 IRA distribution to take a gambling vacation to Las Vegas with her friend from work in July 1996. At that time I asked her how she could afford to go to Las Vegas, as we were experiencing severe cash flow problems. She would not tell me anything about the Las Vegas trip. The tax auditor at the Moab, Utah, office told us about the $5,000 IRA distribution, and that is when Victoria admitted to me that it was the funding source for her trip.

The amount of the understatement of the 1996 Form 1040 additional tax liability for which I am seeking innocent spouse relief is $750, as shown in Worksheet 1 below.

Worksheet 1. **Worksheet for Figuring Tax That Qualifies for Innocent Spouse Relief**
(***Note.*** *This worksheet is optional. Keep it for your records. Do not mail it to the IRS.)*

1.	Enter your total tax including all changed items. ***Note.*** *This should be shown on the IRS notice or audit report.*	1.	***$3,859***
2.	Refigure your total tax by including all items except your spouse's erroneous items. Include items you knew about or had reason to know about.	2.	***$3,109***
3.	**Tax eligible for innocent spouse relief.** Subtract line 2 from line 1.	3.	***$750***

Under the facts and circumstances explained above, I think it would be unfair for IRS to hold me responsible for $750 of the additional tax shown on the 1996 exam report.

General Instructions

A Change To Note

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 made it easier to be relieved from liability of tax related to your spouse (or former spouse). You can now request innocent spouse relief for an understatement of tax no matter how small the amount. If you are divorced, separated, or no longer living with your spouse, you may now request separation of liability between you and your spouse (or former spouse) for an understatement of tax on a joint return. Also, the IRS will consider your request for equitable relief in situations where it would be unfair to hold you liable for tax that should be paid only by your spouse (or former spouse).

The new law applies to any tax liability arising after July 22, 1998, or any tax liability that was unpaid as of that date. For relief of liability for amounts that were paid as of that date, check the box on line 4 and attach the requested statement.

Purpose of Form

Use Form 8857 to request relief from liability for tax, plus related penalties and interest, that you believe should be paid only by your spouse (or former spouse). You generally must have filed a joint return for the year(s) for which you are requesting relief (but see **Community Property Laws** on page 3). The IRS will evaluate your request and tell you if you qualify.

You may be allowed one or more of these three types of relief:

- Separation of liability (see page 3),
- Innocent spouse relief (see page 4), or
- Equitable relief (see page 4).

Attach a statement to Form 8857 explaining why you qualify for relief. Complete the statement using the best information you have available. The IRS will ask you for additional information if needed, or you may provide additional information at any time.

Additional Information

See Pub. 971 for more details.

When and Where To File

When to file. Generally, you should file Form 8857 as soon as you become aware of an unpaid tax liability that you believe should be paid only by your spouse (or former spouse). The following are some of the ways you may become aware of such a liability.

- The IRS has examined your tax return.
- The IRS sends you a notice.

You must file Form 8857 no later than 2 years after the first IRS attempt to collect the tax from you. However, you may file it any time up to 2 years after the first IRS attempt to collect the tax from you that occurs after July 22, 1998. Examples of attempts to collect the tax from you include garnishment of your wages or a notice of intent to levy against your wages or property you own.

Where to file. Do not file Form 8857 with your tax return. Instead, see below.

IF . . .	THEN file Form 8857 with . . .
You are meeting with an IRS employee for an examination, examination appeal, or collection,	That IRS employee.
You received an IRS notice of deficiency, and the 90-day period specified in the notice has not expired,*	The IRS employee named in the notice. Attach a copy of the notice.
None of the situations above apply to you,	**Internal Revenue Service Center Cincinnati, OH 45999-0857**

*Before the end of the 90-day period, you should file a petition with the Tax Court, as explained in the notice. By doing so, you preserve your rights if the IRS is unable to properly consider your request before the end of the 90-day period. Include the information that supports your position, including when and why you filed Form 8857, in your petition to the Tax Court. The time for filing with the Tax Court is **not** extended while the IRS is considering your request.

Tax Court Review of Request

You may petition (ask) the Tax Court to review your request for innocent spouse relief or separation of liability (but not equitable relief) if:

- The IRS sends you a determination notice denying, in whole or in part, your request for relief, **or**
- You do not receive a determination notice from the IRS within 6 months from the date you filed Form 8857.

You may petition the Tax Court to review your case no later than the end of the 90-day period that begins on the date the IRS mails you a determination notice. See Pub. 971 for details on petitioning the Tax Court to review your request.

Joint and Several Liability

Generally, joint and several liability applies to all joint returns. This means that both you and your spouse (or former spouse) are liable for any **underpayment of tax** (tax shown on a return but not paid) plus any **understatement of tax** (defined next) that may become due later. This is true even if a divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns. Form 8857 allows you to request that joint and several liability not apply to part or all of any unpaid tax.

Understatement of Tax

An understatement of tax, or deficiency, is generally the difference between the total amount of tax that the IRS determines should have been shown on the return, and the amount that actually was shown on the return.

Example. You and your spouse (or former spouse) file a joint return showing $5,000 of tax, which was fully paid. The IRS later audits the return and finds $10,000 of income that your spouse earned but did not report. With the additional income, the total tax becomes $6,500. You and your spouse are both liable for the $1,500 understatement of tax.

Underpayment of Tax

An underpayment is tax that is properly shown on the return, but has not been paid.

Example. You filed a joint return that properly reflects your income and deductions, but showed an unpaid balance due of $5,000. You and your spouse were getting divorced. You gave your spouse $2,500 and your spouse promised to pay the full $5,000, but did not. You and your spouse are both liable for the $5,000 underpayment of tax.

Community Property Laws

You must generally follow community property laws when filing a tax return if you are married and live in a community property state. Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Generally, community property laws require you to allocate community income and expenses equally between both spouses. However, state community property laws are not taken into account in determining whether an item belongs to you or to your spouse (or former spouse) for purposes of requesting any relief from liability.

Note: *If you were married and filed a separate return in a community property state and are now liable for an underpayment or understatement of tax you believe should be paid only by your spouse (or former spouse), you may be allowed equitable relief.*

Specific Instructions

Your Current Home Address

Foreign address. Enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code. Please do not abbreviate the country name.

Line 1

If you want to request relief for more than one tax year, you only need to file one Form 8857. If you are filing Form 8857 for multiple years, clearly indicate in the statement(s) you attach the type(s) of relief you are requesting for each year.

Line 2—Information About Your Spouse (or Former Spouse)

Enter the current name and social security number (SSN) of the person to whom you were married at the end of the year(s) listed on line 1. If the name of your spouse (or former spouse) shown on that year's tax return(s) is different from the current name, enter it in parentheses after the current name. For example: Jane Maple (formerly Jane Oak). Enter the current address and phone number if you know it.

P.O. box. Enter the box number instead of the street address **only** if you do not know the street address.

Foreign address. Enter the information as explained under **Your Current Home Address.**

Note: *The IRS is required to inform your spouse (or former spouse) if you request separation of liability or innocent spouse relief, and to allow your spouse (or former spouse) to participate in the determination of the amount of relief from liability.*

Line 3—Separation of Liability

If you filed a joint return for the year(s) entered on line 1, you may be able to separate liability for any understatement of tax on the return(s) between you and your spouse (or former spouse). Generally, you can request to do so if you and that person:

- Are no longer married, or
- Are legally separated, or
- Have lived apart at all times during the 12-month period prior to the date you file Form 8857.

Note: *A widow or widower is considered no longer married.*

Requesting Separation of Liability

Check the box on line 3 and attach a statement to Form 8857. Show the total amount of the understatement of tax. For each item that resulted in an understatement of tax, explain whether the item is attributable to you, your spouse (or former spouse), or both of you. For example, unreported income earned by your spouse (or former spouse), plus any related self-employment tax, would be allocated to that person. An overstated deduction of home mortgage interest on a home you owned jointly that was paid from a joint checking account would generally be allocated equally between both of you. See Pub. 971 for more details.

Exception. If, at the time you signed the joint return, you knew about any item that would result in part or all of the understatement, then your request will not apply to that part of the understatement.

Line 4—Innocent Spouse Relief

TIP *If you qualify for separation of liability, you may not need to request innocent spouse relief. The amount of relief allowed by requesting separation of liability will usually be equal to or greater than the amount allowed by requesting innocent spouse relief. However, you may still request innocent spouse relief if you wish.*

You may be allowed innocent spouse relief if:

- You filed a joint return for the year(s) entered on line 1,
- There is an understatement of tax on the return(s) that is due to erroneous items of your spouse (or former spouse),
- You can show that when you signed the return(s) you did not know and had no reason to know that the understatement of tax existed (or the extent to which the understatement existed), and
- Taking into account all the facts and circumstances, it would be unfair to hold you liable for the understatement of tax.

Erroneous Items

Any income, deduction, or credit is an erroneous item if:

- It is omitted from or incorrectly reported on the joint return,
- It is attributable to your spouse (or former spouse),
- It results in an understatement of tax, **and**
- You either did not know and had no reason to know about the understatement or the extent of it (see **Partial Innocent Spouse Relief** next).

Partial Innocent Spouse Relief

If you knew about any of the erroneous items, but not the full extent of the item(s), you may be allowed relief for part of the understatement. Explain in the statement you attach to Form 8857 how much you knew and why you did not know, and had no reason to know, the full extent of the item(s).

Requesting Innocent Spouse Relief

Check the box on line 4 and attach a statement to Form 8857 explaining why you believe you qualify. The statement will vary depending on your circumstances, but should include the following:

- The amount and a detailed description of each erroneous item, including why you had no reason to know about the item or the extent to which you knew about the item,
- The amount of the understatement of tax for which you are liable and are seeking relief, **and**
- Why you believe it would be unfair to hold you liable for the understatement of tax.

Line 5—Equitable Relief

You may be allowed equitable relief if, taking into account all the facts and circumstances, it would be unfair to hold you liable for any understatement or underpayment of tax that should be paid only by your spouse (or former spouse).

You can only be allowed equitable relief for an underpayment of tax, or part or all of any understatement of tax, that does not qualify for either separation of liability or innocent spouse relief. You should request separation of liability or innocent spouse relief for any understatement of tax, unless you are sure you are not eligible. The IRS will consider equitable relief if it determines that innocent spouse relief and separation of liability do not apply.

Requesting Equitable Relief

Attach an explanation of why you believe it would be unfair to hold **you** liable for the tax instead of your spouse (or former spouse). If you are attaching a statement for separation of liability or innocent spouse relief, include only any additional information you believe supports your request for equitable relief.

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to determine the amount of liability, if any, of which you may be relieved. Internal Revenue Code section 6015 allows relief of liability. If you request relief of liability, you must give us the information requested on this form. Code section 6109 requires you to provide your social security number. Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. If you do not provide all the information in a timely manner, we may not be able to process your request.

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

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Learning about the law or the form,** 17 min.; **Preparing the form,** 17 min.; and **Copying, assembling, and sending the form to the IRS,** 20 min.

If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the form to this address. Instead, see **When and Where To File** on page 2.

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SEPARATE LIABILITY RELIEF [NEW PROVISION—I.R.C. §6015(C)]

Under this new type of relief, a taxpayer may elect to **allocate** (divide) the understatement of tax (including interest and penalties) on a joint return filed with a spouse (or former spouse). In effect, this relief provision limits the amount of the additional tax assessed by an IRS exam to the amount allocable to the electing taxpayer if he or she had filed a separate return.

Note. Separate liability relief can be requested whether or not innocent spouse relief is requested. If a taxpayer qualifies for separate liability relief (as shown below), innocent spouse relief may be unnecessary. **The amount of separate liability relief will usually be equal to or greater than the amount allowed by innocent spouse relief.**

WHO QUALIFIES FOR SEPARATE LIABILITY RELIEF?

To request separate liability relief, a taxpayer must have filed a joint return and meet **either** of the following tests at the time Form 8857 is filed:

1. The taxpayer is no longer married to, or is legally separated from, the spouse with whom the joint return was filed, or
2. The taxpayer was not a member of the same household as the spouse with whom the joint return was filed at any time during the 12-month period ending on the date Form 8857 is filed.

Note. Regarding test 1, a widowed taxpayer is considered "no longer married."

ARE THERE SOME TYPES OF SEPARATE LIABILITY REQUESTS THAT THE IRS WILL REFUSE TO GRANT?

Even if one of the two tests above is met, a separate liability request will be denied by the IRS in the following situations:

- The IRS proves that you and your spouse transferred assets as part of a fraudulent scheme.
- The IRS proves that at the time the joint return was signed, you had knowledge of an incorrect item reported on the return.
- You transferred property to your spouse (or former spouse) to avoid tax or the payment of tax.

HOW IS THE COMPUTATION FOR A SEPARATE LIABILITY REQUEST MADE?

The IRS will figure a taxpayer's separate liability and any related interest and penalties after a taxpayer files Form 8857 and the required statement. However, a taxpayer may compute the separate liability amount by completing Worksheet 2 found in IRS Publication 971 (Rev. December 1998), *Innocent Spouse Relief.*

Example. Chris and Lisa Stowers filed a joint return for 1996. They were divorced in 1997. On July 23, 1998 (the first date the new I.R.C. §6015 provisions became effective), the IRS issued a Notice of Deficiency (exam report) to Chris and Lisa for their joint 1996 return. There were four items (adjustments) shown on the exam report:

1. Chris failed to report $2,378 of nonemployee compensation income for his consulting business.
2. The amount of the additional self-employment tax related to Adjustment 1 is $336 ($2,378 × .9235 × .153).
3. The amount of the additional deduction for half of the self-employment tax related to adjustment 1 is $168.
4. Lisa failed to report $500 of interest income from a certificate of deposit in her name only.

Since Lisa is divorced from Chris, she qualifies to request separate liability relief on Form 8857. Lisa uses Worksheet 2 to compute the portion of the **1996 additional tax** for which she is responsible (line 10 of the worksheet).

Of the four exam adjustments shown above, only one (adjustment 4) applies to Lisa. The first three adjustments are allocated to Chris.

Following are explanations of certain line items on Worksheet 2, which follows.

Line 2. The net amount of income and deduction adjustments shown on the 1996 IRS exam report is $2,710, consisting of:

Unreported nonemployee compensation of Chris	$2,378
Unreported interest income of Lisa	500
Additional self-employment tax deduction	(168)
Line 2 net amount	**$2,710**

Line 4. This is the **additional tax (deficiency)** shown on the 1996 IRS exam report.

Line 5. This is the **additional self-employment tax** (Other Taxes section, on page 2 of the 1996 Form 1040) shown on the 1996 IRS exam report.

Line 6. Lisa enters zero, as the additional tax on her $500 of unreported interest income generated **no additional** credits or other taxes on the 1996 IRS exam report.

Line 10. Lisa's portion of the $743 additional tax shown on the 1996 IRS exam report is $75. The balance of $668 is allocated to Chris.

Note. Lisa will check the line 3 box on Form 8857. She must also attach a statement as explained on page 3 of the instructions for Form 8857.

Worksheet 2. **Worksheet for Figuring Your Separation of Liability**

(Note: This worksheet is optional. Keep it for your records. Do not mail it to the IRS.)

1.	Enter the net amount of income and deductions taken into account in computing the understatement of tax and allocated to you*			1. 500
2.	Enter the net amount of **all** income and deductions taken into account in computing the understatement of tax*			2. 2,710
3.	Divide line 1 by line 2. Enter the result as a decimal (rounded to at least 3 places)			3. .184
4.	Enter the understatement of tax*		4. 743	
5.	Enter the credits and other taxes taken into account in computing the understatement of tax and allocated to your spouse*	5. 336		
6.	Enter the credits and other taxes taken into account in computing the understatement of tax and allocated to you*	6. 0		
7.	Add lines 5 and 6		7. 336	
8.	Subtract line 7 from line 4			8. 407
9.	Multiply line 8 by line 3			9. 75
10.	Add lines 9 and 6. This is the understatement of tax you are responsible for			10. 75

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EQUITABLE RELIEF [NEW PROVISION —I.R.C. §6015(F)]

A taxpayer may not qualify for either innocent spouse or separate liability relief. However, a third type of relief, **equitable relief,** is still available. See line 5 on Form 8857.

REQUIREMENTS FOR QUALIFICATION FOR EQUITABLE RELIEF

All of the following conditions must be met in order to qualify for equitable relief:

1. Taking into account all the facts and circumstances, it would be **unfair** to hold a taxpayer who has filed a joint return liable for any portion of **either** an **understatement of tax** (additional tax assessed by the IRS via an exam report) **or unpaid taxes.**
2. The taxpayer is not eligible for innocent spouse relief.
3. The taxpayer is not eligible for separate liability relief.

Note. Unlike the case for innocent spouse relief or separate liability relief, a taxpayer can be granted relief from paying **unpaid taxes** if his or her equitable relief request is approved by the IRS.

There should be many instances where a taxpayer will qualify to use the new equitable relief provisions of I.R.C. §6015(f) to avoid payment of previously assessed but unpaid taxes.

Example. Tom and Melanie timely filed a joint 1994 tax return. It showed a balance due of $10,000, $5,000 of which remained unpaid as of July 28, 1998. Melanie borrowed $5,000 from her grandfather on April 10, 1995, and used the loan proceeds to pay half of the balance due with the 1994 return. Tom told Melanie he was going to borrow $5,000 from the bank to pay the other half of the balance due, but he did not do so.

Melanie and Tom were divorced in 1997. The IRS is attempting to collect the $5,000 of unpaid 1994 income tax plus substantial interest from Melanie in 1999, as she is a highly paid employee. Tom filed for bankruptcy and has negative net worth. Melanie should file Form 8857 and request equitable relief.

Note. Based on the facts described above and guidance provided in IRS Notice 98-61, the IRS would probably approve Melanie's equitable relief request. (See the discussion of Notice 98-61 in the What's New chapter.)

Summary for Equitable Relief. Practitioners may have several clients who will want to consider the new equitable relief provision. A common situation where this should be considered is if the proper tax was reported on the joint return but remained unpaid as of July 28, 1998, through no fault of one of the spouses.

According to IRS Notice 98-61 (1998-51 IRB, p. 13), a spouse (or former spouse) who requests equitable relief will **ordinarily** be granted relief if the following four conditions are met:

1. The tax reported on a joint return was **unpaid** when the return was filed.
2. The requesting spouse is **no longer married to** or **is legally separated from** the spouse with whom the joint return was filed when Form 8856 is filed.
3. The requesting spouse **did not know, and had no reason to know,** that the tax due would not be paid. In addition, the individual requesting equitable relief should be able to prove that it was **reasonable to expect that the nonrequesting spouse would pay the unpaid taxes.**
4. The requesting spouse would suffer undue hardship [defined in Treas. Reg. §1.6161-19(b)] if relief were denied.

8. QUALIFIED FAMILY-OWNED BUSINESS INTEREST DEDUCTION (I.R.C. §2057)

The qualified family-owned business interest (QFOBI) deduction allows an estate to deduct up to $675,000 from the taxable estate for estate tax purposes if the complex threshold requirements are met. The deduction could reduce estate taxes by as much as $371,250.

To make optimal use of the QFOBI deduction, two important planning issues must be addressed.

1. If a business owner wants his or her estate to benefit from the QFOBI deduction, transfer of the business during life and at death must be carefully planned to ensure that:
   a. The estate qualifies for the QFOBI election, and
   b. The heirs that receive the qualified business interest are able to meet the post-death requirements to avoid the recapture tax.
2. Upon the death of the business owner, the personal representative of the business owner's estate must decide how to divide the $1,300,000 limit between the QFOBI deduction and the unified credit equivalent.

These two issues are discussed below, beginning with the decision on allocating the $1,300,000 limit.

Practitioner Warning. The QFOBI rules are among the most complex rules in the Internal Revenue Code. The following discussion is a basic overview and does not include a detailed discussion of the intricacies of the rules.

A. ALLOCATING THE $1,300,000 LIMIT

In addition to the $675,000 limit, the QFOBI deduction is limited to an amount equal to $1,300,000, reduced by the amount the estate claims as the unified credit equivalent (referred to as the **applicable exclusion amount** under I.R.C. §2010). The applicable exclusion amount is scheduled to increase as follows:

Year	Applicable Exclusion Amount
1999	$ 650,000
2000 and 2001	675,000
2002 and 2003	700,000
2004	850,000
2005	950,000
2006 and thereafter	1,000,000

Therefore, if the estate used the full applicable exclusion amount, the QFOBI deduction would be reduced to $300,000 ($1,300,000 – $1,000,000) in 2006 and thereafter.

However, the personal representative of the estate can choose to allocate up to $675,000 of the $1,300,000 limit to the QFOBI deduction and reduce the applicable exclusion amount to as little as $625,000. There are two important differences between the QFOBI deduction and the applicable exclusion amount:

1. The QFOBI deduction is subtracted from amounts that would otherwise be taxed in the estate's highest marginal tax bracket. By contrast, the applicable exclusion amount is subtracted from amounts that would otherwise be taxed in the estate's lowest tax bracket.
2. If the value of an asset is deducted under the QFOBI rules, the estate tax savings is subject to recapture if the asset does not meet the QFOBI post-death requirements. There is no recapture of taxes saved as a result of the applicable exclusion amount.

The optimal allocation of the $1,300,000 depends on the size of the taxable estate.

Estates greater than $1.3 million will reduce total estate tax liability by claiming the full $675,000 QFOBI deduction. The bigger the estate, the greater the tax savings, since the difference between the estate's highest bracket and lowest bracket is greater.

Example 1. Esther Washington has an estate worth $2,175,000 and has $690,000 of assets that are QFOBI. If Esther dies in 2002 and her estate is still valued as above, her personal representative should elect the full $675,000 QFOBI deduction. That election will limit her applicable exclusion amount to $625,000 (rather than the $700,000 that is otherwise available that year). However, the $75,000 that is claimed as a QFOBI deduction rather than an applicable exclusion amount will come out of the 45% estate tax bracket rather than the 37% bracket. Therefore, estate taxes will be reduced by $6,000.

In contrast, if the estate is $1.3 million or less, the QFOBI election should be made only to shield the assets that exceed the applicable exclusion amount. That election will minimize the assets that are subject to the 10-year recapture tax under I.R.C. §2057(f)(1).

Example 2. Assume that Esther Washington's estate from Example 1 is $1.3 million and her QFOBI is $690,000. If Esther dies in 2002, her $700,000 applicable exclusion amount should be used to shield that much of her estate, and the QFOBI deduction should be used to shield the remaining $600,000. This will reduce her estate taxes to zero and will subject only $600,000 of her assets to the 10-year recapture tax under I.R.C. §2057(f)(1).

B. PLANNING TO MEET THE REQUIREMENTS

To realize the full benefit of the QFOBI deduction, a business owner must plan the transfer of the business to meet both the pre-death and post-death requirements.

PRE-DEATH REQUIREMENTS

To be eligible for the QFOBI election, the following requirements must be met:

Residency. The decedent was (at the date of the decedent's death) a citizen or resident of the United States.

50% Test. The adjusted value of the **qualified family-owned business interests** that are included in the estate or were given away during the decedent's life must exceed 50% of the value of the **adjusted gross estate**.

Qualified family-owned business interests are interests that pass to a family member or an individual who has been an employee of the business for 10 years or more and that meet one of the following requirements.

1. The decedent owned the interest as a proprietor in a trade or business carried on as a proprietorship, or
2. The interest is an interest in an entity carrying on a trade or business and:
   - 50% of such entity is owned (directly or indirectly) by the decedent and members of the decedent's family,
   - 70% of such entity is owned by members of two families, or
   - 90% of such entity is owned by members of three families, and
3. for purposes of (b) or (c), at least 30% of such entity is owned by the decedent and members of the decedent's family.

The statutes exclude the following from being treated as a qualified family-owned business:

- Any interest in a trade or business the principal place of business of which is not located in the United States
- Any interest in an entity, if the stock or debt of such entity or a controlled group [as defined in I.R.C. §267(f)(1)] of which such entity was a member was readily tradable on an established securities market (as defined by the Secretary) at any time within three years of the date of the decedent's death
- Any interest in a trade or business not described in I.R.C. §542(c)(2) (bank or savings and loan association), if more than 35% of the adjusted ordinary gross income of such trade or business for the taxable year which includes the date of the decedent's death would qualify as personal holding company income [as defined in I.R.C. §543(a)].

Observation. Business owners who reduce the business activity of their corporation in their retirement years may have personal holding company income that will disqualify their estate from claiming the QFOBI deduction.

The **adjusted gross estate** is the gross estate (prior to the QFOBI deduction) **reduced** by the decedent's debts and other claims against the estate, and **increased** by most of the gifts the decedent made during his or her life that are not already included in the gross estate. However, gifts to a spouse made more than 10 years before death are not included.

Practitioner Note. Major gifts to a spouse within 10 years of death increase the adjusted gross estate and may create a situation where the 50%-at-death test cannot be met even though these gifts are not otherwise included in the estate.

Five-of-Eight-Year Requirement. During the eight-year period ending on the date of the decedent's death, there must have been periods aggregating five years or more during which:

1. The qualified family-owned business interests were owned by the decedent or a member of the decedent's family, and
2. There was material participation by the decedent or a member of the decedent's family in the operation of the business to which such interests relate.

Practitioner Note. Under the IRS Restructuring and Reform Act of 1998, the trade or business requirement is met if the assets are rented to a family member or (presumably) to a family-owned entity that uses the assets in an active trade or business.

Example 3. Larry Landowner rented his farm to his daughter, Fran, for cash for five of the eight years before his death. Fran used the land in a farm business in which she materially participated. The land is a QFOBI.

POST-DEATH REQUIREMENTS

An additional estate tax (recapture tax) is imposed if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death:

1. The material participation requirements are not met with respect to the qualified family-owned business interest that was acquired (or passed) from the decedent.

2. The qualified heir disposes of any portion of a qualified family-owned business interest [other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under I.R.C. §170(h)].
3. The qualified heir loses U.S. citizenship.

Example 4. Fran (from Example 3) and her brother, Ross, inherit Larry's land equally. Ross rents his half of the land to Fran, who continues to use it in the farming business, in which she materially participates for 10 years after Larry's death. Neither Fran nor Ross will be subject to the recapture tax under I.R.C. §2057.

Practitioner Note. The committee reports clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in recapture of the benefits of the qualified family-owned business exclusion. This language is not in the statutes. It is a significant issue for any business that has assets that turn over in less than the 10-year recapture period.

Proportionate Recapture. If a recapture event occurs with respect to any qualified family-owned business interest (or portion thereof), the amount of reduction in estate taxes attributable to that interest is determined on a proportionate basis.

The portion of the reduction in the estate taxes that is recaptured is dependent on the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100% of the reduction in estate taxes attributable to that heir's interest is recaptured. If the participation was for at least six years, the amount that is recaptured is as shown in the following table:

Years of Participation	Amount Recaptured
At least 6 but less than 7	80%
At least 7 but less than 8	60
At least 8 but less than 9	40
At least 9 but less than 10	20