

INCOME TAX CREDITS

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INTRODUCTION

Deduction or credit—which is better? The answer often depends on your client's income tax bracket. Credits in theory are tax bracket neutral, since they reduce tax directly. However, many personal credits are statutorily reduced or phased out as the taxpayer's income increases. In contrast, deductions reduce tax indirectly, by reducing income subject to tax, and often are more valuable at higher income levels.

A few credits are refundable, allowing a benefit even if the taxpayer has little or no income tax liability. Most credits are nonrefundable, so their benefit is limited by tax liability. Business credits are limited by tentative minimum tax, but for 2001, nonrefundable personal credits are allowed to fully offset the total of an individual's regular income tax and alternative minimum tax. They cannot offset other taxes, such as self-employment tax, household employer taxes, or IRA penalty taxes. Married taxpayers frequently must file joint returns to take advantage of otherwise allowable personal credits.

Business credits generally have carryforward and carryback provisions; personal credits (with the exception of the adoption, mortgage interest credit, and D.C. (District of Columbia) homebuyer credits) do not. Business credits usually are separately stated pass-throughs for partnerships and S corporations. A deduction for certain unused business credits is allowed after the end of the carryover period or in the year an individual taxpayer dies (or a C corporation ceases to exist).

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This chapter focuses primarily on personal credits, but also provides a summary of the foreign tax credit and the investment tax credit deduction.

EARNED INCOME CREDIT (I.R.C. §32)

The refundable earned income credit (EIC) was established by Congress in 1975 to offset the impact of social security taxes on low-income families and to encourage individuals with families to seek employment rather than welfare assistance. Coverage and benefits have expanded significantly in subsequent years.

High error rates have been associated with EIC claims, with several studies citing EIC tax law complexity as a major cause of noncompliance. IRS revenue protection strategies in recent years have concentrated on detecting both mistakes and fraudulent claims. Penalties can be imposed on both taxpayers and preparers who intentionally disregard the EIC rules.

Practitioner Note. Several changes in EIC criteria are effective in 2002. These are discussed in the New Tax Legislation chapter.

1. MAXIMUM AMOUNT OF CREDIT

Earned income, modified adjusted gross income (MAGI), and family size determine the amount of EIC. For 2001, the maximum credit is \$4,008 for eligible families with two or more qualifying children. Taxpayers with no qualifying children or only one qualifying child are eligible for lesser credits with lower total income limits. The following chart from Revenue Procedure 2001-13 shows the maximum credit and income amounts for 2001.

Number of Children	Maximum Amount of the Credit	Earned Income Amount	Threshold Phaseout Amount	Completed Phaseout Amount
1	\$2,428	\$ 7,140	\$13,090	\$28,281
2 or more	\$4,008	\$10,020	\$13,090	\$32,121
None	\$ 364	\$ 4,760	\$ 5,950	\$10,710

2. ELIGIBILITY CRITERIA

In addition to earned income ceilings, eligibility is restricted by:

- Modified adjusted gross income, and
- Investment income

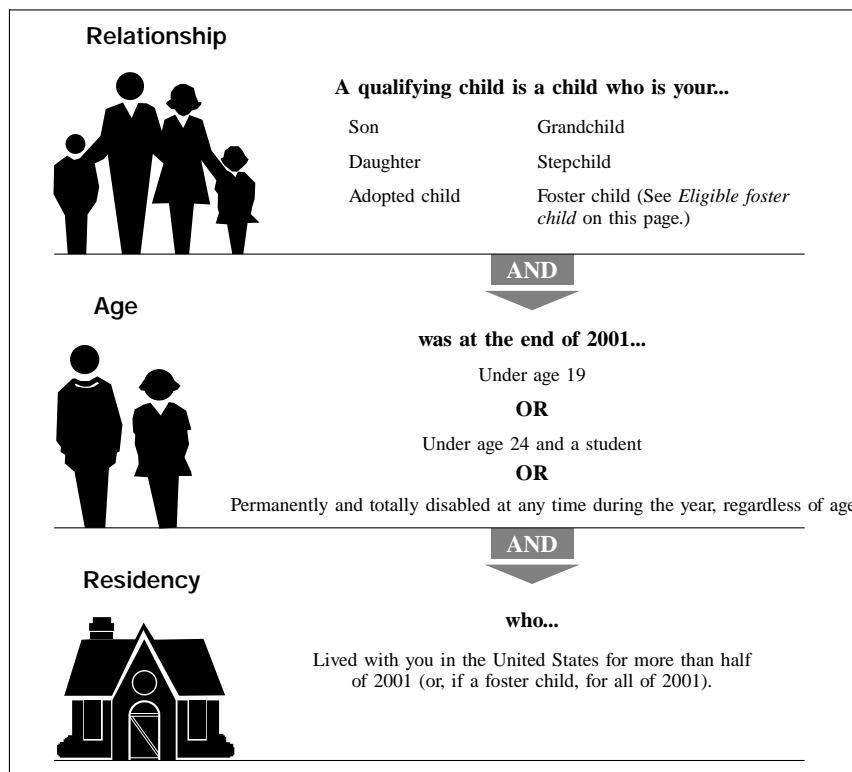
The MAGI and earned income limits are shown in the above chart. The investment income cap for 2001 is \$2,450 for everyone.

Claimants must be U.S. citizens or resident aliens with valid social security numbers that permit work in the United States. They must live in the U.S. for more than half of their tax year and cannot exclude any foreign-earned income.

EIC cannot be claimed on a married filing separate return. It is available to taxpayers with any other filing status. A 1990 law change eliminated the rule that had required an unmarried taxpayer to qualify as head of household to be eligible for EIC.

3. QUALIFYING CHILDREN

Qualifying children must meet relationship, age, and residency tests, and must have valid social security numbers. The following chart is from IRS Publication 596, *Earned Income Credit*. If more than one person has the same qualifying child, a tiebreaker rule limits eligibility to the person with the higher MAGI. When the tiebreaker rule applies, the lower income taxpayer cannot claim EIC, including the no-child EIC.



For 2001, an eligible foster child is a child who lives with the taxpayer for the entire year and is cared for as the taxpayer's own child. The child must be placed with the taxpayer by an authorized placement agency or be the taxpayer's sibling, stepsibling, or a descendant of the taxpayer's sibling or stepsibling.

A married child is an eligible child only if the taxpayer claims a dependency exemption for the child.

A taxpayer who is a qualifying child is ineligible to receive the credit on his or her own return.

Example 1. Sheila and Gregory divorced in 1997. They have two children, now aged 8 and 11. The parents have joint legal custody but Sheila has primary physical custody. In 2001, both children lived with Gregory every other weekend and for six weeks in the summer. Otherwise, they lived with Sheila and no other adult. The divorce decree grants Gregory the dependency exemptions for the children. However, the children are not qualifying children for Gregory for EIC, because the residency test is not met.

Example 2. Barbara and Carl separated in May 2001, when Barbara vanished, leaving Carl with their 10 children aged 7 to 18. They are not divorced, but Carl meets the qualifications to be treated as unmarried and file as head of household. The children are his qualifying children for EIC.

Example 3. Emily and Kenneth separated in October 2001. Their divorce hearing will be in January 2002. Since they do not meet the criteria to be considered unmarried, they must file a joint return to be eligible for EIC.

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Example 4. Amy, 25, is an unmarried mother who lived all year in her parents' home with her 2-year-old son, Jason. Amy's MAGI was \$12,000; her parents' MAGI was \$60,000. Jason is a qualifying child for both Amy and her parents. Since her parents' MAGI is higher, Amy is ineligible for EIC.

Example 5. Bob and Tom are brothers who shared an apartment all year with Tom's sons, aged 8 and 10. Bob cares for the children as his own. The boys are qualifying children for both Bob and Tom, so the brother with the higher MAGI is the only one eligible for EIC.

Example 6. Judy and Susan are cousins who share an apartment with their children. Both Judy and Susan may be eligible for EIC based on their own children, since the relationship test is not met for the foster child rule.

Example 7. Neil and Nancy are not married but they live together with their children. Whichever parent has the higher MAGI is eligible for EIC.

Example 8. Matt and Louise, who are not married, live together with Louise's children from other relationships. Louise has no earned income; Matt, who earned \$18,000, supported the family. No one is eligible for EIC, since the children are not qualified foster children for Matt.

Example 9. Oliver and Karen live together with their daughter, Caitlin, born to them in October 2001, and his sons from a prior marriage. They are not married. Oliver's MAGI is \$12,000 and Karen's MAGI is \$15,000. Both may qualify for EIC. Since Oliver's MAGI is lower than Karen's, Karen wins the tiebreaker for Caitlin. But since his sons are not qualifying children for Karen, he may claim EIC for the sons.

Example 10. Chris, a single father, died in a car accident in March 2001. His children lived with him before the accident. His will designated a cousin who lived nearby as guardian after his death. Chris's final return may include an earned income credit claim because his children lived with him for more than half his taxable year, and they are not qualifying children for anyone else in 2001.

Example 11. Lanier died in August 2001. He and his sister Edith had shared a home with his daughter Betty. Edith had always acted as a mother to Betty and was named as her guardian after Lanier's death. Since Betty is a qualifying child for both Lanier and Edith, whoever has the higher MAGI is eligible for EIC.

4. NO QUALIFYING CHILD

Two additional eligibility criteria apply to taxpayers who do not have a qualifying child:

- The claimant must be at least age 25 but under age 65.
- The claimant cannot be a dependent of another person.

If a joint return is filed, only one taxpayer needs to have earned income and only one needs to meet the age limits.

Example 12. Loretta, age 63, and Barry, age 68, are married with no qualifying children. Loretta has no earned income. Barry worked part-time and earned \$8,000. Their only other income is \$25,000 in nontaxable social security benefits. Loretta and Barry qualify for EIC on a joint return.

5. WHAT IS EARNED INCOME?

Earned income for 2001 includes almost all income received from working, even if it is not taxable.

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Taxable earned income includes:

- Wages, salaries, and tips
- Union strike benefits
- Employer disability benefits received before minimum retirement age, and
- Net earnings from self-employment (after the self-employment tax deduction)

Practitioner Note. Strike benefits and disability benefits that qualify as earned income should be entered on line 7 of Form 1040 or 1040A to ensure correct crediting when the IRS processes the return.

Nontaxable earned income includes:

- Salary deferrals [for example, 401(k) plans]
- Military combat zone pay
- Basic housing and subsistence allowances, and in-kind housing and subsistence for the U.S. military
- The value of meals or lodging provided by an employer for the convenience of the employer
- Housing allowance or rental value of a parsonage for the clergy, and
- Benefits provided by an employer (such as dependent care, educational assistance, and adoption benefits) and salary reductions (for example, under a cafeteria plan)

Wages are qualified earned income even if they are exempt from social security tax, but **self-employment amounts that are exempt from self-employment tax for religious reasons** (Forms 4029 and 4361) **are not included**.

Losses from self-employment reduce earned income. Thus, deduction options (such as a choice between an I.R.C. §179 expense deduction and depreciation) may increase or decrease EIC.

Taxpayers with negative earned income are not eligible for EIC. However, if an optional method is used to figure self-employment tax, the taxpayer is deemed to have net earnings from self-employment, rather than a loss.

Example 13. Dan and Shari have three preschool children. Dan's Form W-2 shows wages in box 1 of \$30,000 and a \$3,000 contribution to his 401(k) plan in box 12. Shari has a \$5,000 loss from her cosmetology business, including \$800 of depreciation on new equipment. Their earned income for EIC is \$28,000 (\$30,000 + \$3,000 - \$5,000).

Example 14. Shari's new equipment cost \$8,000. Since Dan's wages qualify as business income, she is eligible to elect §179 expensing, increasing her loss to \$12,200. This reduces their earned income to \$20,800.

Example 15. Frank and Eleanor have four qualifying children. Eleanor earned \$10,000 as a substitute teacher. Frank has a \$15,000 loss on Schedule F and is eligible to use the farm optional method of computing self-employment tax. If Frank does not elect the optional method, the couple has negative earned income and no possibility of earned income credit. If Frank chooses the optional method, the couple has \$11,478 of earned income, computed as follows:

Wages	\$10,000
Net earnings from self-employment	\$ 1,600
Half of self-employment tax	(\$ 122)
Total	\$11,478

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Example 16. Denise earned a total of \$3,600 as a domestic employee from five different employers. She received no Forms W-2 because her earnings from each employer were less than \$1,300. Denise's wages are earned income for EIC. The \$3,600 should be entered on line 7 of Form 1040 or 1040A and noted as "HSH."

Example 17. Isaac has an approved Form 4029 exempting him from self-employment tax. He has a Schedule C profit of \$8,000 and wages from a part-time job of \$12,000. Only the \$12,000 is earned income for EIC.

Example 18. Isaac from Example 17 also has a Schedule F loss of \$16,000. His earned income for EIC is still \$12,000, since the loss does not reduce his earned income.

Example 19. Lois is an ordained minister who has an approved Form 4361. She has \$4,000 of income on Schedule W-2 and a housing allowance of \$6,000, plus a Schedule C profit of \$8,000. Her earned income for EIC is \$10,000 (\$4,000 + \$6,000).

6. WHAT IS MODIFIED AGI?

Modified AGI (adjusted gross income) is the same as AGI for many people. But if the taxpayer has tax-exempt interest, return of investment exclusions from pension, annuity or IRA distributions, losses on Schedule C, C-EZ, D, E, or F, or claims a loss from rental of personal property not used in a trade or business, modifications to AGI are required. The following amounts are added back to AGI:

- Any net capital loss claimed on Form 1040 (line 13)
- Any net estate or trust loss claimed on Schedule E (line 36)
- Any royalty loss claimed on Schedule E (line 26)
- Three-fourths of **each** of the following losses:
 - Any Schedule C business loss on Form 1040 (line 12)
 - Any Schedule F farm loss on Form 1040 (line 18)
 - Any loss determined by combining any rental real estate income or (loss) included on line 26 of Schedule E, and the amounts on lines 31 (partnerships and S corporations) and 39 (farm rental income) of Schedule E
- Any loss from the rental of personal property not used in a trade or business (the amount by which the expenses for the rental deducted as an adjustment to line 32, Form 1040, are more than the income from the rental included on line 21, Form 1040)
- Any tax-exempt interest shown on line 8b of Form 1040 or 1040A
- The nontaxable part of a pension, annuity, or individual retirement arrangement (IRA) distribution, except amounts that are nontaxable because of trustee-to-trustee transfers or rollover distributions

Practitioner Note. When an IRA or pension distribution is totally rolled over, the distribution is entered on line 15a or 16a of Form 1040 (line 11a or 12a of Form 1040A) and -0- is entered on line 15b or 16b (line 11b or 12b of Form 1040A). "Rollover" should be written in next to the "b" line. If this is omitted, or the IRS processing center does not identify the entry, EIC often will be denied in a math error adjustment because the MAGI limit is exceeded.

Example 20. Dan and Shari from Example 13 have no other income. Their AGI is \$25,000; their MAGI is \$28,750 (adding back \$3,750, $\frac{3}{4}$ of the \$5,000 loss).

Example 21. If Shari elected the \$179 expense as in Example 14, their AGI would be \$17,800 but their MAGI would be \$26,950 (adding back \$9,150, $\frac{3}{4}$ of the \$12,200 loss).

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Example 22. Frank and Eleanor from Example 15 have AGI of (\$5,122) and MAGI of \$6,128 (adding back \$11,250, $\frac{3}{4}$ of the \$15,000 Schedule F loss).

Example 23. Isaac has AGI and MAGI of \$20,000 in Example 17. In Example 18, his AGI is \$4,000 and his MAGI is \$16,000 (adding back \$12,000 of the loss).

Example 24. Mary has wages of \$10,000, a Schedule D loss of (\$3,000), and a rental loss of (\$10,000). Her AGI is (\$3,000); her MAGI is \$7,500, after adding back the \$3,000 capital loss and \$7,500 of the rental loss.

7. WHAT IS INVESTMENT INCOME?

Investment income includes:

- All interest and dividends, whether taxable or tax-exempt
- Capital gain net income
- Net royalties
- Net income from nonbusiness rental of personal property
- Net income from passive activities (including real estate rentals)

Losses from any of the above do not reduce income in the other categories.

Practitioner Note. Capital gain net income is net gain from Schedule D minus any gains from sales of business property carried to Schedule D from Form 4797. Business property includes cull cows and farm equipment properly reported on Form 4797. If Schedule D is not required, capital gain net income equals the capital gains distributions entered directly on Form 1040 or Form 1040A.

Example 25. Irene has a \$16,000 gain on Schedule D, but \$15,000 of it is from sale of business property reported on Form 4797. Irene's net capital gain is \$1,000. She has \$300 of dividend income, \$200 of tax-exempt interest, and a \$4,000 rental loss. Her investment income for EIC is \$1,500 (\$1,000 + \$300 + \$200).

Example 26. Harry frequently trades online and has a \$43,000 net capital loss on Schedule D (limited to \$3,000). His return shows \$2,000 of dividends, \$300 of interest, and a \$500 net profit from rental real estate reported on Schedule E, as well as his wages of \$20,000. His investment income for EIC is \$2,800 (\$2,000 + \$300 + \$500).

Example 27. Marvin rents an office building to his wholly owned S corporation and usually has a profit of \$100 a month. In December 2001, the corporation prepaid the \$900 rent for January. As a cash-basis taxpayer, Marvin's Schedule E reflects 13 months of income and 12 months of expenses, for a profit of \$2,100. He also has \$500 of interest income. Marvin's investment income for EIC is \$2,600.

Observation. Under the self-rental rule of Treas. Reg. 1.469-2(f)(6), when a taxpayer rents property to his own business, the net rental income can be recharacterized as nonpassive for the passive loss rules. (See Issue 2 in the Individual Problems chapter.) But since the underlying activity is still passive, the net rent is still included in investment income for EIC (FSA 200120036 and SCA 200120037).

8. DETERMINING THE CREDIT

If a taxpayer's MAGI is below the phaseout threshold, EIC is a percentage of the earned income amount. If MAGI exceeds the phaseout threshold (based on the number of qualifying children), the credit may be reduced (but not increased) by the phaseout percentage of the excess MAGI.

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The percentages are:

Number of Children	Credit	Phaseout
1	34%	15.98%
2 or more	40%	21.06%
None	7.65%	7.65%

Tax preparers do not need to compute these amounts because I.R.C. §32(f) requires use of IRS tables for determining the credit. If MAGI exceeds the phaseout threshold, the smaller of the credits based on earned income and MAGI is the allowable EIC.

Example 28. Dan and Shari from Examples 13 and 20 have earned income of \$28,000 and MAGI of \$28,750. The two-child EIC for \$28,000 is \$863; it drops to \$705 at \$28,750. Their EIC is \$705.

Example 29. With the I.R.C. §179 deduction in Examples 14 and 21, their earned income is \$20,800 (EIC of \$2,379) and their MAGI is \$26,950 (EIC of \$1,084). Their EIC is \$1,084.

Observation. EIC is only one consideration. With five exemptions and a standard deduction, Dan and Shari's income tax would be zero with AGI of \$22,100. Although the I.R.C. §179 deduction increases EIC, the couple permanently loses the benefit of \$4,300 of deductions and the nonrefundable child tax credit.

Example 30. Frank and Eleanor from Examples 15 and 22 have earned income of \$11,478 and MAGI of \$6,128. Since their MAGI is less than the phaseout threshold, their EIC is \$4,008, based on the \$11,478 of earned income.

Example 31. Isaac from Examples 18 and 23 has one qualifying child. EIC based on \$12,000 of earned income is \$2,428; EIC based on a \$16,000 MAGI is \$1,959. Isaac's EIC is \$1,959.

9. TAXPAYER IDENTIFYING NUMBERS

The taxpayer(s)—both husband and wife on a joint return—and any qualifying children all must have valid social security numbers (SSNs) for EIC to be allowed. Adoption Taxpayer Identification Numbers (ATINs) and Individual Taxpayer Identification Numbers (ITINs) do not qualify. If a taxpayer or qualifying child receives an SSN after the original return is filed, EIC may be claimed on an amended return filed before the statute of limitations for refund expires.

There is no allowable deviation from the SSN rule, even when taxpayers have religious objections to participation in social security. Courts consistently have ruled that there is no exception to the statutory requirement in I.R.C. §32(m).

10. RECERTIFICATION AND PENALTIES

When EIC is disallowed or reduced for any reason other than a clerical or mathematical error, the claimant must be recertified before EIC is allowable in a future year. Form 8862 must be attached to the subsequent return claiming EIC. IRS may request additional information after a properly completed Form 8862 is attached to a return.

If a taxpayer is found to have intentionally or recklessly disregarded the EIC rules, EIC cannot be allowed for the next two tax returns filed after the date of the determination. Form 8862 is required after the end of the two-year period. If a determination of fraud is made, the prohibited period is 10 years.

An EIC preparer penalty under I.R.C. §6695(g) was included in 1997 tax legislation. The due diligence requirements of Regulation §1.6695-2 are effective for returns due after October 16, 2000. The penalty is assessed only through examination. Notices assessing the penalty read as follows:

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“We charged you a penalty for not meeting the due diligence requirements for the Earned Income Credit (EIC). The penalty is \$100 for each EIC you prepared that didn’t meet the requirements. Please pay the balance due within 10 days from the date of this notice. If you wish to contest the amount due, you must first pay the penalty, then file a claim for refund on Form 6118, Claim for Refund of Income Tax Return Preparer Penalties. You may obtain Form 6118 from most IRS offices. You have three years from the date of payment to file a claim.”

Form 8867 can be used to satisfy the regulatory requirement for completion of an eligibility checklist. It should be retained for three years after June 30th following the date the return was presented to the taxpayer for signature. The Form 8867 shown was completed for Dan and Shari’s return (Example 28).

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Form **8867**
(Rev. November 2000)
Department of the Treasury
Internal Revenue Service

Paid Preparer's Earned Income Credit Checklist

OMB No. 1545-1629

▶ **Do not send to the IRS. Keep for your records.**

For the definitions of the following terms, see Pub. 596 for the year for which you are completing this form.

- Investment Income • Qualifying Child • Modified AGI • Earned Income • Nontaxable Earned Income

Caution: Taxpayers who file Form 2555 or Form 2555-EZ cannot claim the earned income credit (EIC). Taxpayers who were nonresident aliens for any part of the year cannot claim the EIC unless their filing status is married filing jointly.

Part I All Taxpayers

- 1 Enter the taxpayer's name ▶ Dan and Shari Smith-Jones
and the year for which you are completing this form ▶ 2001
- 2 Is the taxpayer's filing status married filing jointly, head of household, qualifying widow(er), or single? Yes No
- 3 Does the taxpayer, and the taxpayer's spouse if filing jointly, have a social security number (SSN) that allows him or her to work? See the instructions before answering Yes No
- Note:** If you checked "No" on line 2 or line 3, stop; the taxpayer cannot claim the EIC. Otherwise, continue.
- 4 Is the taxpayer's investment income more than the limit that applies to the year on line 1? See Pub. 596 for the limit Yes No
- 5 Could the taxpayer, or the taxpayer's spouse if filing jointly, be a qualifying child of another person in the year on line 1? Yes No
- Note:** If you checked "Yes" on line 4 or line 5, stop; the taxpayer cannot claim the EIC. Otherwise, go to Part II or Part III, whichever applies.

Part II Taxpayers With a Qualifying Child

Caution: If there are two children, complete lines 6–11 for one child before going to the next column.

	Child 1	Child 2
6 Is the child— • The taxpayer's son, daughter, or adopted child, or • A descendant of the taxpayer's son, daughter, or adopted child, or • The taxpayer's stepchild, or • The taxpayer's eligible foster child?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
7 If the child is married, is the taxpayer claiming the child as a dependent? (If the child is not married, check "Yes.")	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
8 Did the child live with the taxpayer in the United States for over half of the year, or the full year if the child is an eligible foster child?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
9 Was the child (at the end of the year on line 1)— • Under age 19, or • Under age 24 and a full-time student, or • Any age and permanently and totally disabled?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<p>Did you check "Yes" on lines 6 through 9?</p> <p><input checked="" type="checkbox"/> Yes. The child is the taxpayer's qualifying child. But the child may also be the qualifying child of one or more other taxpayers who could check "Yes" on lines 6 through 9. Go to line 10.</p> <p><input type="checkbox"/> No. The child is not the taxpayer's qualifying child. If the taxpayer does not have a qualifying child, go to Part III on the back to see if the taxpayer can claim the EIC for taxpayers who do not have a qualifying child.</p>		
10 Is the taxpayer's modified AGI higher than the modified AGI of all other taxpayers for whom the child is a qualifying child?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
11 Does the qualifying child have an SSN? See the instructions before answering	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No

Did you check "Yes" on line 10 and line 11?

- Yes.** The taxpayer can claim the EIC if the taxpayer's earned income and modified AGI are each less than the limit that applies to the year on line 1. See Pub. 596 for the limit. Complete **Schedule EIC** and attach it to the taxpayer's return. If there are two qualifying children with SSNs, list them on Schedule EIC in the same order as they are listed here. Also, enter any **nontaxable earned income** on the appropriate line of the taxpayer's return for the year on line 1. If the taxpayer's EIC was reduced or disallowed for a year after 1996, see Pub. 596 to find out if **Form 8862** must also be filed.
- No.** The taxpayer cannot claim the EIC, not even the credit for taxpayers who do not have a qualifying child.

For Paperwork Reduction Act Notice, see back.

Cat. No. 26142H

Form **8867** (Rev. 11-2000)

Part III Taxpayers Without a Qualifying Child

- 12** Was the taxpayer's main home, and the taxpayer's spouse if filing jointly, in the United States for more than half the year? (Military personnel on extended active duty outside the United States are considered to be living in the United States during that duty period.) **Yes** **No**
- 13** Was the taxpayer, or the taxpayer's spouse if filing jointly, at least age 25 but under age 65 at the end of the year on line 1? **Yes** **No**
- Note:** If you checked "No" on line 12 or line 13, **stop**; the taxpayer **cannot** claim the EIC. Otherwise, continue.
- 14** Is the taxpayer, or the taxpayer's spouse if filing jointly, eligible to be claimed as a dependent on anyone else's Federal income tax return for the year on line 1?
- No.** The taxpayer can claim the EIC if the taxpayer's **earned income** and **modified AGI** are each less than the limit that applies to the year on line 1. See Pub. 596 for the limit. Also, any **nontaxable earned income** must be entered on the appropriate line of the taxpayer's return for the year on line 1. If the taxpayer's EIC was reduced or disallowed for a year after 1996, see Pub. 596 to find out if **Form 8862** must be filed.
- Yes.** The taxpayer **cannot** claim the EIC.

General Instructions

Purpose of Form

Paid preparers of Federal income tax returns or claims for refund involving the earned income credit (EIC) must meet the due diligence requirements in determining if the taxpayer is eligible for, and the amount of, the EIC. Failure to do so could result in a \$100 penalty for each failure. See Internal Revenue Code section 6695(g).

Due Diligence Requirements. You will meet the due diligence requirements if **all four** of the following apply.

- You complete Form 8867 (or your own form as long as it provides the same information as Form 8867).
- You complete the EIC worksheet(s) in the Form 1040, 1040A, or 1040EZ instructions, or in Pub. 596 (or your own worksheet(s) as long as it provides the same information as the 1040, 1040A, 1040EZ, or Pub. 596 worksheet(s)).
- You have no knowledge that any of the information used to determine if the taxpayer is eligible for, and the amount of, the EIC is incorrect.
- You keep the following information for 3 years*:
 - Form 8867 (or your own form), **and**
 - The EIC worksheet(s) (or your own worksheet(s)), **and**
 - A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained.

*For returns and claims for refund due after October 16, 2000, the 3-year period begins the June 30th following the date you give the return or claim to the taxpayer to sign.

Specific Instructions

Line 2

If the taxpayer was married at the end of the year, he or she must usually file a joint return to claim the EIC. However, if the taxpayer and his or her spouse were not living together at the end of the year, the taxpayer may be eligible to be treated as unmarried. See **Pub. 596**, Earned Income Credit, for details.

Line 3

For purposes of taking the EIC, an SSN is a number issued by the Social Security Administration to a U.S. citizen or to a person who has permission from the Immigration and Naturalization Service to work in the United States. It does not include an SSN issued only to allow a person to apply for or receive Federally funded benefits. You may find it useful to look at the social security card.

Line 6

An **adopted child** includes a child placed with the taxpayer by an authorized placement agency for legal adoption even if the adoption is not final. An authorized placement agency includes any person authorized by state law to place children for legal adoption.

A **descendant** usually refers to a grandchild or great-grandchild of the taxpayer.

An **eligible foster child** is a child the taxpayer cared for as his or her own child and who lived with the taxpayer for the whole year. But see Pub. 596 for an exception if the child did not live with the taxpayer for the required time. **For years after 1999**, to be an eligible foster child a child must also be (a) a brother, sister, stepbrother, or stepsister of the taxpayer; (b) a descendant (such as a child, including an adopted child) of a brother, sister, stepbrother, or stepsister of the taxpayer; or (c) a child placed with the taxpayer by an authorized placement agency.

See Pub. 596 for more details on the relationship test for qualifying children.

Line 7

If the child is married and the child's other parent claimed him or her as a dependent under the special rules for children of divorced or separated parents, check "Yes."

Line 10

If no one else lived with the taxpayer and the child, check "Yes." Also check "Yes" if the taxpayer is married filing jointly and the only other person who lived with the taxpayer and the child was the taxpayer's spouse.

You must ask the taxpayer if his or her modified AGI is higher than the modified AGI of any other taxpayer for whom the child is a qualifying child. If necessary, you must explain to the taxpayer what modified AGI means. However, you do not have to verify the amount of any other taxpayer's modified AGI.

Line 11

See the line 3 instructions for the definition of an SSN. If the child does not have an SSN because he or she was born and died in the year entered on line 1, check "Yes."

Paperwork Reduction Act Notice. We ask for you to obtain the information on this form to carry out the Internal Revenue laws of the United States. You are required to obtain this information.

You are not required to obtain 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 Internal Revenue Code section 6103.

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping**, 13 min.; **Learning about the law or the form**, 8 min.; and **Preparing the form**, 24 min.

If you have comments concerning the accuracy of these time estimates 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, keep it for your records.



2001 Workbook

CHILD TAX CREDIT (I.R.C. §24)

For 2001, taxpayers may claim a credit of up to \$600 for each qualifying child. A qualifying child must be:

- Claimed as the taxpayer's dependent
- Under age 17 at the end of 2001
- The taxpayer's son, daughter, adopted child, descendant of a child, stepchild, or foster child, and
- A U.S. citizen or resident alien as defined in I.R.C. §7701(b) (see the Small Business Problems chapter).

1. INCOME LIMITATIONS

The credit is limited if the taxpayer's modified adjusted gross income (MAGI) exceeds a threshold based on filing status, which is:

- \$110,000 if married filing jointly
- \$75,000 if single, head of household, or qualifying widow(er), and
- \$55,000 if married filing separately

Modified adjusted gross income adds back any excluded foreign-earned income or income from Puerto Rico or American Samoa. If the taxpayer's income exceeds the above amount, the additional income is rounded up to the next \$1,000 and then multiplied by 5%. The 5% reduces the otherwise allowable amount of credit.

Example 31. George and Kate have a \$124,200 MAGI and two qualifying children. Their credit without the phaseout would be \$1,200. Their MAGI is rounded up to \$125,000, and their credit reduction is 5% of \$15,000, or \$750. Their child tax credit is limited to \$450.

2. TAX LIABILITY LIMITATIONS

The child tax credit can offset both regular income tax and alternative minimum tax. In previous years, it was not refundable unless the taxpayer had three or more qualifying children. Those taxpayers could compute an additional child tax credit on Form 8812, which was refundable to the extent that the taxpayer's social security and self-employment taxes exceeded any EIC.

Beginning in 2001, the additional child tax credit can be refundable for taxpayers with any number of qualifying children, if their taxable earned income exceeds \$10,000. The new credit is not affected by EIC or social security taxes. Form 8812 has been revised to include this computation. Taxable earned income is computed using the EIC rules.

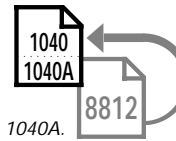
Practitioner Note. Many clients who in the past have not benefited from the child tax credit because of a zero or low tax liability will be able to take advantage of the new credit.

Example 32. Marvin from Example 27 has two qualifying children for the child tax credit. He is the noncustodial parent, but his ex-wife signed Form 8332 relinquishing the children's dependency exemptions. In addition to his \$2,600 of rental and interest income, Marvin has wages from his corporation of \$15,000 and a \$3,000 capital loss deduction, resulting in an AGI of \$14,600. His standard deduction of \$4,550 and three exemptions of \$2,900 each total \$13,250, leaving him taxable income of \$1,350 and a tax of \$204. His child tax credit before the tax liability limitation is \$1,200. Since his taxable earned income exceeds \$10,000, Marvin qualifies for a refundable additional child tax credit of \$500, computed on Form 8812.

2001 Workbook

Form **8812**

Additional Child Tax Credit



OMB No. 1545-1620

2001

Attachment Sequence No. **47**

Department of the Treasury
Internal Revenue Service

Complete and attach to Form 1040 or Form 1040A.

Name(s) shown on return

Marvin

Example 32

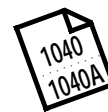
Your social security number

- Before you begin:**
- ✓ Complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 47, or Form 1040A, line 30.
 - ✓ If you have three or more qualifying children:
 - Have your W-2 form(s) available.
 - If filing **1040A** and you, or your spouse if filing jointly, had more than one employer for 2001 and total wages of over \$59,700, figure any excess social security and railroad retirement (RRTA) taxes withheld. See the instructions for Form 1040A, line 41.

1 Enter the amount from line 1 of your Child Tax Credit Worksheet on page 37 of the Form 1040 instructions or page 38 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 3 of the publication.	1	1,200
2 Enter the amount from Form 1040, line 47, or Form 1040A, line 30.	2	204
3 Subtract line 2 from line 1. If zero, stop ; you cannot take this credit.	3	996
4 Enter your total taxable earned income. See the instructions on back.	4	15,000
5 Is the amount on line 4 more than \$10,000? <input type="checkbox"/> No. Leave line 5 blank, enter -0- on line 6, and go to line 7. <input checked="" type="checkbox"/> Yes. Subtract \$10,000 from the amount on line 4. Enter the result.	5	5,000
6 Multiply the amount on line 5 by 10% (.10) and enter the result.	6	500
7 Is the amount on line 1 \$1,800 or more? <input checked="" type="checkbox"/> No. If you also checked the “No” box on line 5, stop ; you cannot take this credit. Otherwise, leave lines 7 through 12 blank and go to line 13. <input type="checkbox"/> Yes. Enter the total of the withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse’s amounts with yours. If you worked for a railroad, see the instructions on back.	7	
8 1040 filers: Enter the total of the amounts from Form 1040, lines 27 and 54, plus any uncollected social security and Medicare or RRTA taxes included on line 58. 1040A filers: Enter -0-.	8	
9 Add lines 7 and 8.	9	
10 1040 filers: Enter the total of the amounts from Form 1040, lines 61a and 62. 1040A filers: Enter the total of the amount from Form 1040A, line 39a, plus any excess social security and RRTA taxes withheld that you entered to the left of line 41.	10	
11 Subtract line 10 from line 9. If zero or less, enter -0-.	11	
12 Enter the larger of line 6 or line 11.	12	
13 Look at the checkboxes on line 7. If you checked— • “No,” enter the smaller of line 3 or line 6. • “Yes,” enter the smaller of line 3 or line 12.	13	500

This is your additional child tax credit.

Enter this amount on
Form 1040, line 63, or
Form 1040A, line 40.



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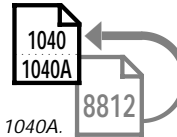
Cat. No. 10644E

Form **8812** (2001)

2001 Workbook

Form **8812**

Additional Child Tax Credit



OMB No. 1545-1620

2001

Attachment
Sequence No. **47**

Department of the Treasury
Internal Revenue Service

Complete and attach to Form 1040 or Form 1040A.

Name(s) shown on return

Dan and Shari

Example 33

Your social security number

Before you begin:

- ✓ Complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 47, or Form 1040A, line 30.
- ✓ If you have three or more qualifying children:
 - Have your W-2 form(s) available.
 - If filing **1040A** and you, or your spouse if filing jointly, had more than one employer for 2001 and total wages of over \$59,700, figure any excess social security and railroad retirement (RRTA) taxes withheld. See the instructions for Form 1040A, line 41.

1 Enter the amount from line 1 of your Child Tax Credit Worksheet on page 37 of the Form 1040 instructions or page 38 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 3 of the publication.	1	1,800
2 Enter the amount from Form 1040, line 47, or Form 1040A, line 30.	2	144
3 Subtract line 2 from line 1. If zero, stop ; you cannot take this credit.	3	1,656
4 Enter your total taxable earned income. See the instructions on back.	4	25,000
5 Is the amount on line 4 more than \$10,000? <input type="checkbox"/> No. Leave line 5 blank, enter -0- on line 6, and go to line 7. <input checked="" type="checkbox"/> Yes. Subtract \$10,000 from the amount on line 4. Enter the result.	5	15,000
6 Multiply the amount on line 5 by 10% (.10) and enter the result.	6	1,500
7 Is the amount on line 1 \$1,800 or more? <input type="checkbox"/> No. If you also checked the “No” box on line 5, stop ; you cannot take this credit. Otherwise, leave lines 7 through 12 blank and go to line 13. <input checked="" type="checkbox"/> Yes. Enter the total of the withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse’s amounts with yours. If you worked for a railroad, see the instructions on back.	7	2,525
8 1040 filers: Enter the total of the amounts from Form 1040, lines 27 and 54, plus any uncollected social security and Medicare or RRTA taxes included on line 58. 1040A filers: Enter -0-.	8	
9 Add lines 7 and 8.	9	2,525
10 1040 filers: Enter the total of the amounts from Form 1040, lines 61a and 62. 1040A filers: Enter the total of the amount from Form 1040A, line 39a, plus any excess social security and RRTA taxes withheld that you entered to the left of line 41.	10	705
11 Subtract line 10 from line 9. If zero or less, enter -0-.	11	1,820
12 Enter the larger of line 6 or line 11.	12	1,820
13 Look at the checkboxes on line 7. If you checked— • “No,” enter the smaller of line 3 or line 6. • “Yes,” enter the smaller of line 3 or line 12.	13	1,656

This is your additional child tax credit.

Enter this amount on
Form 1040, line 63, or
Form 1040A, line 40.



For Paperwork Reduction Act Notice, see back of form.

Cat. No. 10644E

Form **8812** (2001)

Example 33. Dan from Example 28 has \$2,524.50 of social security and medicare taxes withheld and shown on his Form W-2. He and Shari have itemized deductions of \$9,550 and their five exemptions total \$14,500. Their taxable income is \$950 and their income tax is \$144. Their child tax credit before tax liability limitations is \$1,800. They have no other credits. Under prior law, they would have received a \$144 regular child tax credit and a \$1,656 additional child tax credit, as shown on their completed Form 8812. They will receive the same credits under the revised law for 2001.

Example 34. Marilyn is a divorced custodial parent who receives \$500 a month in child support for her three daughters, all under age 12. Her only income is her wages of \$15,000. She has no nontaxable earned income. After subtracting her standard deduction as head of household and four exemptions, she has no taxable income. She is entitled to EIC of \$3,600, as shown on her completed 2001 Form 8812. Her W-2 shows social security and medicare tax withholding totaling \$1,147.50. In prior years with similar income, she received no benefit from the child tax credit. In 2001, she will receive an additional \$500 refund.

3. ORDERING OF CREDITS

Four nonrefundable credits—the foreign tax credit, child and dependent care credit, credit for the elderly and disabled, and education credits—reduce tax before the child tax credit is used. Three personal credits that can carry forward—the adoption credit, the mortgage interest credit, and the D.C. home-buyer credit—will carry forward to allow current use of the child tax credit. Worksheets in the form instructions and IRS Publication 972 are used to determine the interaction of the credits.

4. QUESTIONS AND ANSWERS

Question 1. Can a custodial parent claim the child tax credit if the noncustodial parent claims the child as a dependent?

Answer 1. The custodial parent cannot claim the credit for a child in the tax year that the noncustodial parent takes the exemption for that child. Unlike EIC, the child tax credit cannot be separated from the dependency exemption.

Question 2. Can taxpayers using a filing status of married filing separately claim the additional child credit?

Answer 2. Yes. Form 8812, Additional Child Tax Credit, must be completed.

Question 3. Is a grandchild, who is a dependent, eligible for the child tax credit?

Answer 3. A grandchild under the age of 17 who is the grandparent's dependent and is a U.S. citizen or resident alien is a qualifying child for the child tax credit.

Question 4. Can I claim the child tax credit for a client whose child has an ITIN, not a social security number?

Answer 4. Yes, if the child otherwise qualifies. Although children living in Canada and Mexico can meet the residency test for dependency exemptions, they must live in the United States to qualify for the child tax credit.

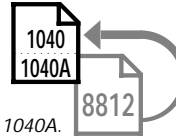
Question 5. My client's child lived for only 12 days and never received a social security number, because the Social Security Administration will not issue a social security number for a deceased child. Can I still use the child tax credit?

Answer 5. Yes. Attach a copy of the child's birth certificate and enter "died" in column 2 of line 6c. You will also need to put a check mark in column 4 of line 6c.

2001 Workbook

Form **8812**

Additional Child Tax Credit



OMB No. 1545-1620

2001

Attachment
Sequence No. **47**

Department of the Treasury
Internal Revenue Service

Complete and attach to Form 1040 or Form 1040A.

Name(s) shown on return

Marilyn

Example 34

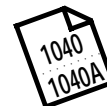
Your social security number

Before you begin:

- ✓ Complete the Child Tax Credit Worksheet that applies to you. See the instructions for Form 1040, line 47, or Form 1040A, line 30.
- ✓ If you have three or more qualifying children:
 - Have your W-2 form(s) available.
 - If filing **1040A** and you, or your spouse if filing jointly, had more than one employer for 2001 and total wages of over \$59,700, figure any excess social security and railroad retirement (RRTA) taxes withheld. See the instructions for Form 1040A, line 41.

1 Enter the amount from line 1 of your Child Tax Credit Worksheet on page 37 of the Form 1040 instructions or page 38 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 3 of the publication.	1 1,800
2 Enter the amount from Form 1040, line 47, or Form 1040A, line 30.	2 0
3 Subtract line 2 from line 1. If zero, stop ; you cannot take this credit.	3 1,800
4 Enter your total taxable earned income. See the instructions on back.	4 15,000
5 Is the amount on line 4 more than \$10,000? <input type="checkbox"/> No. Leave line 5 blank, enter -0- on line 6, and go to line 7. <input type="checkbox"/> Yes. Subtract \$10,000 from the amount on line 4. Enter the result.	5 5,000
6 Multiply the amount on line 5 by 10% (.10) and enter the result.	6 500
7 Is the amount on line 1 \$1,800 or more? <input type="checkbox"/> No. If you also checked the “No” box on line 5, stop ; you cannot take this credit. Otherwise, leave lines 7 through 12 blank and go to line 13. <input type="checkbox"/> Yes. Enter the total of the withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse’s amounts with yours. If you worked for a railroad, see the instructions on back.	7 1,148
8 1040 filers: Enter the total of the amounts from Form 1040, lines 27 and 54, plus any uncollected social security and Medicare or RRTA taxes included on line 58. 1040A filers: Enter -0-.	8 0
9 Add lines 7 and 8.	9 1,148
10 1040 filers: Enter the total of the amounts from Form 1040, lines 61a and 62. 1040A filers: Enter the total of the amount from Form 1040A, line 39a, plus any excess social security and RRTA taxes withheld that you entered to the left of line 41.	10 3,600
11 Subtract line 10 from line 9. If zero or less, enter -0-.	11 0
12 Enter the larger of line 6 or line 11.	12 500
13 Look at the checkboxes on line 7. If you checked— • “No,” enter the smaller of line 3 or line 6. • “Yes,” enter the smaller of line 3 or line 12.	13 500

This is your additional child tax credit.



Enter this amount on
Form 1040, line 63, or
Form 1040A, line 40.

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 10644E

Form **8812** (2001)

EDUCATION CREDITS (I.R.C. §25A)

The two education tax credits—the Hope Credit and the Lifetime Learning Credit—are based on education expenses paid for the taxpayer, spouse, and dependents. Both credits may be claimed on the same tax return, but only one of them can be claimed for each student. The amount of the credit is determined by the amount of qualified tuition and related expenses paid for each student, and by the taxpayer’s modified adjusted gross income (MAGI).

Qualified expenses for both credits are tuition and fees required for enrollment or attendance at an accredited college, university, vocational school, or other postsecondary educational institution that is eligible to participate in a student aid program administered by the Department of Education. Expenses paid with nontaxable educational assistance do not qualify.

Qualified expenses do not include room and board, insurance, transportation, or other similar personal, living, or family expenses. They include charges for books, supplies, and equipment **only** if the fee must be paid to the school for the student’s enrollment or attendance. In addition, qualified expenses may include student activity fees if the fee must be paid to the school for the student’s enrollment or attendance.

1. HOPE CREDIT

An eligible student for the Hope Credit is a student who:

1. Is enrolled (for at least one academic period beginning during the tax year) in an undergraduate program that leads to a degree, certificate, or other recognized educational credential
2. Has not amassed the equivalent of two years of academic credit for the degree or credential program as of the beginning of the tax year, disregarding credits awarded solely on the basis of proficiency examinations
3. Is taking at least half the normal full-time workload for at least one academic period beginning during the tax year, and
4. Has not been convicted of a federal or state felony offense for possessing or distributing a controlled substance as of the end of the tax year

The Hope Credit can be claimed for only two tax years for each eligible student. The maximum Hope Credit is \$1,500 for each eligible student (100% of the first \$1,000 of qualified tuition and related expenses, plus 50% of the next \$1,000 of such expenses).

Example 35. Marian, age 44, earned a master’s degree in library science in 1980 but now has decided her true career goal is to be an executive chef. She enrolled full-time in August 2001 in an accredited two-year program at a culinary institute that gives no credit for her prior graduate or undergraduate work. A prior degree is not a prerequisite for the culinary program. Marian does not have a felony drug conviction. She is a qualifying student for the Hope Credit.

Example 36. Oliver earned his GED in July 1998 and has been taking one or two college classes per semester most semesters since then, always attending less than half time. As of January 2001, he had earned 27 credit hours, five hours short of his school’s requirement for junior standing. He enrolled at least half time in January. State charges of marijuana possession were dismissed in 1994 after he completed a drug education diversion program. Oliver is a qualifying student for the Hope Credit in 2001.

2. LIFETIME LEARNING CREDIT

The Lifetime Learning Credit (LLC) is 20% of the first \$5,000 of qualified expenses paid for all students in the family, for a maximum of \$1,000 per tax return. It does not increase based on the number of students with qualified expenses.

2001 Workbook

The Lifetime Learning Credit's application is much broader than the Hope Credit in the following ways:

1. It is not based on the student's workload.
2. It is allowed for one or more courses that the student takes at an eligible educational institution.
3. It is not limited to students in the first two years of postsecondary education. Expenses for graduate-level degree work are eligible.
4. There is no limit on the number of tax years for which the credit can be claimed for each student.

Classes may be taken for credit toward a degree or educational credential, or to acquire or improve job skills. Education involving sports, games, and hobbies does not qualify unless it is part of a degree program.

If a tuition expense would qualify as both a deduction and a business expense, the taxpayer must choose between the two benefits.

Example 37. Andrew decides to learn American Sign Language (ASL) to improve communication with his hearing-impaired clients. He enrolls in a night course at his local high school career center for a fee of \$240, course book included. Andrew may deduct the \$240 as a business expense, but it does not qualify for the LLC because the school is not a postsecondary educational institution.

Example 38. Andrew enrolls in basically the same ASL course at a community college for a fee of \$300 (text included, furnished by the instructor). Andrew may choose between a business deduction and the LLC for the \$300 expense.

3. CREDIT PHASEOUT

An education credit is reduced for taxpayers with MAGI of \$40,000 to \$50,000 (\$80,000 to \$100,000 for joint returns), and is eliminated at a \$50,000 MAGI (\$100,000 for joint returns). It cannot be claimed on a married filing separate return. MAGI is figured the same way as for the child tax credit.

Example 39. Dick and Jane paid \$20,000 in tuition for their twin sons' freshman year tuition. Their adjusted gross income is \$95,000 and their tax liability is \$8,000. They have no other credits. Their Hope Credit is reduced from \$3,000 to \$750 (see Dick and Jane's completed Form 8863).

Form 8863	Education Credits (Hope and Lifetime Learning Credits)	OMB No. 1545-1618 2001 Attachment Sequence No. 50
Department of the Treasury Internal Revenue Service	▶ See instructions on pages 2 and 3. ▶ Attach to Form 1040 or Form 1040A.	
Name(s) shown on return Dick and Jane		Your social security number Example 38

Part I Hope Credit. Caution: *The Hope credit may be claimed for no more than 2 tax years for the same student.*

1	(a) Student's name (as shown on page 1 of your tax return) First, Last	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but do not enter more than \$2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
	<i>Twin I</i>	123 45 6789	2,000	1,000	1,000	500
	<i>Twin L</i>	987 65 4321	2,000	1,000	1,000	500
2	Add the amounts in columns (d) and (f)		2	2,000		1,000
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f)				3	3,000

2001 Workbook

Part III Allowable Education Credits

8	Tentative education credits. Add lines 3 and 7	8	3,000
9	Enter: \$100,000 if married filing jointly; \$50,000 if single, head of household, or qualifying widow(er)	9	100,000
10	Enter the amount from Form 1040, line 34 (or Form 1040A, line 20)*	10	95,000
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop ; you cannot take any education credits	11	5,000
12	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	12	20,000
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)	13	× .25
14	Multiply line 8 by line 13 ▶	14	750
15	Enter the amount from Form 1040, line 42 (or Form 1040A, line 26)	15	8,000
16	Enter the total, if any, of your credits from Form 1040, lines 43 through 45 (or from Form 1040A, lines 27 and 28)	16	0
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop ; you cannot take any education credits	17	8,000
18	Education credits. Enter the smaller of line 14 or line 17 here and on Form 1040, line 46 (or Form 1040A, line 29) ▶	18	750

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

For Paperwork Reduction Act Notice, see page 4.

Cat. No. 25379M

Form 8863 (2001)

If a student qualifies for the Hope Credit but prefers to save the Hope Credit for a future year, the Lifetime Learning Credit may be used instead. Taxpayers may change their credit elections on timely filed amended returns.

4. QUESTIONS AND ANSWERS

Question 1. A student finished the college sophomore year in June and began the junior year in September. Can the student take the Hope Credit for the spring semester and the Lifetime Learning Credit for the fall semester expenses?

Answer 1. No, you cannot take both credits in one year for the same student. But expenses for both semesters will qualify for the Hope Credit, unless it has already been claimed for two years for that student.

Question 2. Are expenses to attend private high schools eligible for the education credits?

Answer 2. No, it must be postsecondary education. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary postsecondary institutions.

Question 3. Many high school seniors are also enrolled in colleges for dual credits. Are the fees paid to the college eligible for one of the education tax credits?

Answer 3. College courses taken while attending high school may qualify if the student meets the qualifications for claiming either of the credits. Sometimes the student is not admitted to a degree program before high school graduation.

Question 4. If my client puts money into a college savings plan for his children, is that money eligible for either the Hope or Lifetime Learning Credit?

2001 Workbook

Answer 4. No, an education credit is claimed in the year in which the expenses are paid, not in the year in which money is set aside in a savings plan.

Question 5. If tuition was paid by a government subsidized loan, can I still take the Hope or Lifetime Learning Credit?

Answer 5. Expenses paid with loans that must be repaid do qualify. The credit is claimed in the year in which the expenses are paid, not in the year in which the loan is repaid.

Question 6. A divorced father pays college tuition for his child who is claimed as a dependent on the ex-wife's return. Is the divorced father eligible for the educational credit?

Answer 6. No. In order to claim an education credit for a child, the parent must claim the child as an exemption. The ex-wife is eligible to claim the credit for the expenses paid by the other parent.

MORTGAGE INTEREST CREDIT (I.R.C. §25)

The mortgage interest credit program was authorized by Congress in 1984 to help low- and moderate-income individuals afford home ownership. To be eligible for the credit, the prospective home-buyer must receive a mortgage credit certificate (MCC) through a state or local government housing finance agency program. Normal market-rate mortgage loans are obtained through participating lenders. Taxpayers with MCCs may use Form W-4 to reduce their withholding, thereby increasing take-home pay available to make mortgage payments.

An MCC will show the certificate credit rate used to figure the credit and the certified indebtedness amount on which the interest is eligible for the credit. The rate may be 20%, 25%, 30%, or 35%, depending on the mortgage amount.

Observation. Maximum qualifying income and home purchase price limits vary with the locality as well as family size. The following information is from housing agency Web sites:

Area	Family (3+) Income Limit	Maximum Home Price
Indianapolis	\$69,805	\$130,000
Philadelphia	\$69,020	\$170,500
Honolulu	\$74,730	\$266,740
San Mateo County, CA	\$66,240	\$369,100

Form 8396 is completed to compute the credit. If the mortgage does not exceed the MCC certified indebtedness amount, all interest paid on the mortgage during the year is entered on line 1. If the mortgage does exceed the certified indebtedness amount, the credit is based on only part of the interest paid. The MCC amount is divided by the original mortgage amount; the resulting percentage is applied to the interest amount paid each year. The percentage will not change as long as the taxpayer can take the credit.

Example 40. Ellen bought a home with an \$80,000 mortgage loan. The certified indebtedness amount on her MCC is \$60,000 (75% of the mortgage amount). Each year, 75% of Ellen's mortgage interest may be entered on Form 8396; the other 25% may be used only as an itemized deduction on Schedule A (Form 1040).

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1. CREDIT LIMITATIONS

Two different dollar limits apply: a limit based on the credit rate, and a limit based on tax.

- If the certificate credit rate is higher than 20%, the total credit for all holders of the certificate cannot be more than \$2,000. After applying that limit, the credit cannot exceed the total of the taxpayer's regular and alternative minimum taxes, minus other nonrefundable personal credits, as computed on Form 8396.
- If the otherwise allowable credit exceeds the limit based on net tax, the unused portion of the credit can carry forward to the next three years or until used, whichever comes first. Amounts that exceed the \$2,000 limit do not carry forward.

Practitioner Note. The home mortgage interest deduction otherwise allowable on Schedule A must be reduced by the amount of the mortgage interest credit.

Example 41. Ellen's regular tax liability for 2000 was \$1,001 and she had no alternative minimum tax or other credits. Her mortgage interest credit was \$1,280. The unused mortgage interest credit of \$279 (\$1,280 – \$1,001) is carried forward to 2001. She cannot elect to deduct it on Schedule A (Form 1040) instead.

Example 42. Ellen paid \$5,600 of mortgage interest during 2001. Her MCC credit rate is 30%. Her credit for 2001 is \$1,539 (see completed Form 8396). In addition, she may deduct \$4,340 of her mortgage interest on Schedule A (Form 1040) [\$1,400 (25% of \$5,600) + \$2,940 (\$4,200 – \$1,260) = \$4,340].

Form 8396 <small>Department of the Treasury Internal Revenue Service (99)</small>	Mortgage Interest Credit (For Holders of Qualified Mortgage Credit Certificates Issued by State or Local Governmental Units or Agencies.) ► Attach to Form 1040.	OMB No. 1545-0930 2001 Attachment Sequence No. 53
Name(s) shown on Form 1040 Ellen		Your social security number : : :
Enter the address of your main home to which the qualified mortgage certificate relates if it is different from the address shown on Form 1040.		

Part I Current Year Mortgage Interest Credit		
1 Interest paid on the certified indebtedness amount. If someone else (other than your spouse if filing jointly) also held an interest in the home, enter only your share of the interest paid	1	4,200
2 Enter the certificate credit rate shown on your mortgage credit certificate	2	30 %
3 If line 2 is 20% or less, multiply line 1 by line 2. If line 2 is more than 20%, or if you refinanced your mortgage and received a reissued certificate, see the instructions for the amount to enter <i>Note: You must reduce your deduction for home mortgage interest on Schedule A (Form 1040) by the amount on line 3.</i>	3	1,260
4 Enter any credit carryforward from 1998 (line 18 of your 2000 Form 8396)	4	0
5 Enter any credit carryforward from 1999 (line 16 of your 2000 Form 8396)	5	0
6 Enter any credit carryforward from 2000 (line 19 of your 2000 Form 8396)	6	279
7 Add lines 3 through 6	7	1,539
8 Enter the amount from Form 1040, line 42	8	3,154
9 Add the amounts from Form 1040, lines 43 through 47, and enter the total	9	0
10 Subtract line 9 from line 8. If line 9 is equal to or more than line 8, enter -0- here and on line 11 and go to Part II	10	3,154
11 Current Year Mortgage Interest Credit. Enter the smaller of line 7 or line 10. Also include this amount in the total on Form 1040, line 49 and check box b on that line	11	1,539

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2. MULTIPLE OWNERS

If two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person.

Example 43. John and his brother Jim were issued an MCC to purchase a home in which John has a 60% ownership interest and Jim has a 40% ownership interest. The MCC shows a credit rate of 25%. Because the credit rate is more than 20%, the total credit is limited to \$2,000. John has a credit limit of \$1,200 and Jim has a limit of \$800.

3. REFINANCING

If an MCC loan is refinanced, the homeowner must get a new MCC to claim the credit on the new loan. An issuer may reissue an MCC only up to one year after the date of the refinancing. Certified mortgage indebtedness can increase, but the term of reissued MCC must remain the same as the original MCC even if the term of the refinanced mortgage is extended.

Example 44. John and Jim received a 25-year mortgage in 1995. In 2001, they refinanced over a new 20-year period. Their reissued MCC cannot extend beyond the original 25 years.

In the year of refinancing, if an MCC is reissued, the allowable interest paid on the old mortgage and the allowable interest paid on the new mortgage are added and the total is entered on line 1 of Form 8396. If the new MCC has a different credit rate than the old MCC, you must attach a statement to Form 8396 showing the separate calculations for lines 1, 2, and 3 for the part of the year each MCC was in effect. Combine the amounts of each line 3, put the total on line 3 of the form, and note "See attached" on the dotted line.

Practitioner Note. A reissued MCC is effective as of the date of the mortgage refinancing. If the MCC is reissued after the tax return for the refinancing year is filed, an amended return can be filed to claim the additional credit.

The credit claimed for a reissued MCC cannot be more than the credit allowable under the original MCC. On fixed-rate loans, the agency ensures that the credit is not increased. However, if either loan has a variable (adjustable) interest rate, the return preparer needs to make a comparison using one of these methods:

1. Figure the actual credit that would have been allowed, using the credit rate on the old MCC and the interest that would have been paid on that loan.
2. Figure a hypothetical credit using a payment schedule for a self-amortizing mortgage with level payments projected to the final maturity date of the old mortgage. The interest rate to be used is the annual percentage rate of the new mortgage under the Truth in Lending Act, and the principal is the remaining balance of the old MCC's certified mortgage indebtedness.

Either method must be used consistently, beginning with the first tax year for which a credit is based on the new MCC. The old MCC and the schedule of payments for the old mortgage must be retained as part of tax records.

4. RECAPTURE [I.R.C. §143(m)]

Homeowners who received MCCs after 1990 may have to recapture all or part of the tax benefit when a sale or other disposition occurs. Exclusion of gain on sale does not affect the recapture tax. Sale or other disposition includes an exchange, involuntary conversion, or any other disposition.

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Example 45. Ellen decides to move into a retirement community and give her home to her newly married grandson. For purposes of the recapture tax, she is deemed to have sold the house for its fair market value on the transfer date.

Recapture applies only if both of the following conditions are met:

1. The home is sold at a gain during the first nine years after the closing date of the MCC mortgage loan.
2. The owner's income for the year of disposition is more than the adjusted qualifying income based on family size for that year.

Observation. At or near the time of settlement of the MCC mortgage loan, the homebuyer received a notice that provides the federally subsidized amount and other information needed to figure the recapture tax. If this information has been misplaced, the mortgage lender or housing agency should be contacted for the necessary information.

Recapture does not apply if the home is:

- Disposed of as a result of the owner's death
- Transferred to a spouse or former spouse incident to a divorce, and no gain is included in the owner's income, or
- Destroyed by a casualty, and repaired or replaced on its original site within two years after the end of the year the casualty occurred

Refinancing, with or without a reissued MCC, does not result in recapture, but it also does not cancel the recapture provision. A later sale or disposition after the refinancing may result in recapture. The recapture percentage can be reduced if the MCC loan is fully repaid within four years of the closing date and before the date of disposition of the home.

The recapture tax is the lesser of 50% of the gain (or deemed gain) on sale of the property, or 6.25% of the original certified mortgage indebtedness. It is computed on Form 8828. If a home financed with a loan subject to the recapture rules is sold, Form 8828 must be attached to the seller's tax return even if no recapture tax is owed.

Example 46. Ellen's basis in her home is \$85,000 and it was worth \$100,000 when she transferred the title to her grandson. He obtained a new loan for the remainder of her mortgage. Ellen is deemed to have sold the home and must recapture part of the benefit of her MCC. Ellen's MCC documents state that her federally subsidized amount is \$3,750 (6.25% of \$60,000) (see Ellen's completed Form 8828), and include the following table:

Home Sold during Year *	Holding Period%	Family Members Living in Home at Time of Sale	
		2 or less	3 or less
1	20%	\$ 60,000	\$ 69,000
2	40%	63,000	72,000
3	60%	66,150	76,073
4	80%	69,458	79,876
5	100%	72,930	83,870
6	80%	76,577	88,063
7	60%	80,406	92,467
8	40%	84,426	97,090
9	20%	88,647	101,944

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Form **8828**
(Rev. November 1998)
Department of the Treasury
Internal Revenue Service

Recapture of Federal Mortgage Subsidy

OMB No. 1545-1288

Attachment
Sequence No. **64**

▶ Attach to Form 1040. ▶ See separate instructions.

Name(s) **Ellen** **Example 46** Social security number (as shown on page 1 of your tax return)

Part I Description of Home Subject to Federally Subsidized Debt

1 Address of property (number and street, city or town, state, and ZIP code)

2 Check the box that describes the type of Federal subsidy you had on the loan for your home.

- a Mortgage loan from the proceeds of a tax-exempt bond
- b Mortgage credit certificate

Note: If neither box applies, you are not subject to recapture tax on the sale or other disposition of your home. **DO NOT** complete this form.

3 Name of the bond or certificate issuer _____
State Political subdivision (city, county, etc.) Agency, if any

4 Name and address of original lending institution _____

5 Date of closing of the original loan 7 - 15 - 98
Month Day Year

Note: If the date of closing of the loan was before January 1, 1991, recapture tax does not apply. **DO NOT** complete this form. If you (1) checked the box on line 2b (mortgage credit certificate), (2) refinanced your home, and (3) received a reissued mortgage credit certificate, see **Refinancing your home** on page 1 of the instructions.

6 Date of sale or other disposition of your interest in the home 7 - 10 - 02
Month Day Year

7 Number of years and full months between original closing date (line 5) and date of sale or disposition (line 6): **3** **11**
Years Full months

8 Date of full repayment of the original loan including a refinancing other than one for which a replacement mortgage credit certificate was issued (see instructions) 7 - 10 - 02
Month Day Year

Part II Computation of Recapture Tax

9 Sales price of your interest in the home sold or disposed of (see instructions)	9	100,000
10 Expenses of sale. Include sales commissions, advertising, legal fees, etc.	10	300
11 Amount realized. Subtract line 10 from line 9	11	99,700
12 Adjusted basis of your interest in the home sold or disposed of (see instructions)	12	85,000
13 Gain or (loss) from sale or disposition. Subtract line 12 from line 11. If a loss, stop here and attach this form to your Form 1040. You do not owe recapture tax	13	14,700
14 Multiply line 13 by 50% (.50)	14	7,350
15 Modified adjusted gross income (see instructions)	15	70,000
16 Adjusted qualifying income (see instructions)	16	66,150
17 Subtract line 16 from line 15. If zero or less, stop here and attach this form to your Form 1040. You do not owe recapture tax	17	3,850
18 Income percentage. If the amount on line 17 is \$5,000 or more, enter "100." Otherwise, divide the amount on line 17 by \$5,000 and enter the result as a percentage. Round to the nearest whole percentage	18	77%
19 Federally subsidized amount (see instructions) . 6.25% of \$60,000	19	3,750
20 Holding period percentage (see instructions)	20	60%
21 Multiply line 19 by the percentage on line 20	21	2,250
22 Recapture amount. Multiply line 21 by the percentage on line 18	22	1,733
23 Tax. Enter the smaller of line 14 or line 22. Also, include this amount on the line for total tax on Form 1040. For details, see the Instructions for Form 1040	23	1,733

For Paperwork Reduction Act Notice, see page 2 of separate instructions.

Cat. No. 13049F

Form **8828** (Rev. 11-98)

FIRST-TIME HOMEBUYER CREDIT (I.R.C. §1400C)

The first-time homebuyer credit is available only to taxpayers who purchase a principal residence within the District of Columbia. First-time means that the buyer has not owned a main home in Washington, D.C., during a one-year period ending on the date of purchase of the new home.

- The home can be a house, houseboat, house trailer, cooperative apartment, condominium, or other shelter.
- The maximum credit is \$5,000 per home. If there are multiple owners, allocation of the \$5,000 limit is decided by the owners. The credit is not refundable, but it carries forward indefinitely. It cannot carry back to years prior to the home's purchase. It can offset both regular tax and alternative minimum tax.
- The credit is computed on Form 8859. It is reduced for taxpayers whose MAGI exceeds \$70,000 (\$110,000 if married filing jointly) and eliminated at \$90,000 (\$130,000 for joint returns). MAGI is the same as for the education and child tax credits. Married taxpayers who file separate returns are eligible for the credit, but the maximum credit is reduced to \$2,500.
- The credit reduces the taxpayer's basis in the home, and cannot exceed the home's purchase price.

Example 47. Bert and Bart purchased a condo in Washington for \$240,000 to use as their main home. Bert has a 65% ownership interest and Bart has a 35% interest. Bert's MAGI is \$100,000 and Bart's is \$55,000. Bert agrees that the entire \$5,000 of credit should be allocated to Bart (see Bart's completed Form 8859).

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Form **8859**
 Department of the Treasury
 Internal Revenue Service

District of Columbia First-Time Homebuyer Credit

▶ Attach to Form 1040.

OMB No. 1545-1584

2000

Attachment
Sequence No. **106**

Name(s) shown on Form 1040

Bart

Example 47

Your social security number

Note: Skip Parts I and II if you have a credit carryforward from 1999.

Part I General Information

A Address of home qualifying for the credit (if different from the address shown on Form 1040)

Information from
settlement statement
or deed

B Lot number

C Square number

D Settlement or closing date

Part II Tentative Credit

1 Enter: \$5,000 if single, married filing jointly, head of household, or qualifying widow(er); \$2,500 if married filing separately. If the purchase price of the home was less than \$5,000, enter the purchase price (one-half of the purchase price if married filing separately). If someone other than a spouse also held an interest in the residence, enter only your share of the \$5,000 amount (or, if smaller, your share of the purchase price) (see instructions)

1 **5,000**

2 Enter your modified adjusted gross income (see instructions)

2 **55,000**

3 Is line 2 more than: \$70,000 if single, married filing separately, head of household, or qualifying widow(er); \$110,000 if married filing jointly?

No. Skip lines 3 and 4 and enter -0- on line 5.

Yes. Subtract from the amount on line 2: \$70,000 if single, married filing separately, head of household, or qualifying widow(er); \$110,000 if married filing jointly

3

4 Divide line 3 by \$20,000 and enter the result as a decimal (rounded to at least three places). **Do not** enter more than "1.000"

4 × .

5 Multiply line 1 by line 4

5 **0**

6 Subtract line 5 from line 1. This is your **tentative credit**

6 **5,000**

Part III Credit Carryforward From 1999

7 Enter the amount from line 12 of your 1999 Form 8859

7

Part IV Tax Liability Limit

8 Enter the amount from Form 1040, line 42

8 **8,845**

9 Add the amounts from Form 1040, lines 43 through 48, and any mortgage interest credit included on Form 1040, line 49

9 **0**

10 Subtract line 9 from line 8. If zero or less, enter -0-

10 **8,845**

11 **Credit allowed for current year.** If you completed Part II, enter the **smaller** of line 6 or line 10. If you completed Part III, enter the **smaller** of line 7 or line 10. Also include this amount in the total for Form 1040, line 49; check box **d**; and enter "8859" in the space for the form number

11 **5,000**

12 **Credit carryforward to 2001.** Subtract line 11 from line 6 or line 7, whichever applies

12 **0**

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 24779G

Form **8859** (2000)

FOREIGN TAX CREDIT (I.R.C. §901)

The foreign tax credit (FTC) is intended to reduce the double tax burden that could arise if foreign-source income is taxed by both the United States and the foreign country. Generally, only income taxes paid or accrued to a foreign country or a U.S. possession qualify for the foreign tax credit. Qualified foreign taxes do not include taxes that are refundable or taxes paid to countries whose government is not recognized by the United States.

Taxpayers may choose between two tax benefits for qualified foreign taxes—the FTC or a deduction. To choose the deduction for nonbusiness income, individuals must itemize deductions on Schedule A.

Neither a credit nor a deduction is permitted for taxes paid or accrued on income that is excluded under the foreign-earned income exclusion or the foreign housing exclusion. There is no double taxation in this situation because the income is not subject to U.S. income tax.

To choose the FTC, Form 1116 generally must be filed with an income tax return. A credit limit is computed separately for each type of foreign income. The maximum credit is the smaller of:

- The amount of foreign tax paid or accrued, or
- The amount of U.S. tax attributable to foreign source income

When the full amount of qualified foreign taxes paid or accrued cannot be used, a two-year carry-back and then a five-year carryover of the unused foreign tax may be allowed.

Observation. The FTC offsets regular tax only. However, a separate calculation of FTC is made for alternative minimum tax purposes. It reduces the tentative minimum tax on Form 6251.

SIMPLIFIED METHOD [I.R.C. §904(j)]

Individuals can claim a credit for the full amount of foreign taxes—without filing Form 1116 and separately computing U.S. tax on the foreign-source income—if the following requirements are met:

1. The only gross income from foreign sources for the tax year is from interest and dividends reported on a Form 1099-DIV or 1099-INT.
2. The qualified foreign taxes for the tax year are not more than \$300 (\$600 for a joint return) and are reported on a Form 1099.
3. If there is dividend income, the stock was held for at least 16 days.
4. Income from Puerto Rico or American Samoa is not being excluded.
5. The taxpayer forgoes a carryover or carryback of any unused foreign tax to or from this year.

Example 48. Karen elects the simplified method. She received a 2001 Form 1099-DIV from her long-time mutual fund investment showing \$67 of foreign income taxes withheld. The dividends are her only foreign-source income. The \$67 is entered on line 43 of Form 1040 without completion of Form 1116.

Practitioner Note. If Karen is potentially liable for alternative minimum tax (AMT), her AMT FTC must be computed on Form 1116. However, she also may elect a simplified limitation for preparing the AMT Form 1116. Part I and lines 14–16 are completed using regular tax amounts. The simplified limitation must be elected in the first tax year after 1997 when the taxpayer claims an AMT FTC.

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EFFECT OF THE TREATY WITH GERMANY

The tax treaty between Germany and the United States can increase the U.S. foreign tax credit above the amount of German tax actually paid. A grossed up amount is included in income and then used as part of the credit. The following example is based on information from Daimler-Chrysler AG's Web site at <http://daimlerchrysler.com> (go to "Investor Relations" and then "Questions and Answers").

Many current and former auto industry employees who owned Chrysler stock now receive Daimler-Chrysler AG dividends with German income tax withheld. The usual German withholding tax is 26.375% of the dividend, but 16.375% is refundable from German tax authorities, reducing the effective rate to 10%. Article 10 of the tax treaty between Germany and the United States provides for a tax credit on the U.S. return for that 10.0%, plus an additional deemed tax credit for 5.88% of the dividend.

U.S. shareholders may apply for the 16.375% German refund through the Bank of New York or directly from the German taxing authority, the Bundesamt für Finanzen. Shareholders with Daimler-Chrysler stock held in "street" name or within a mutual fund should have automatically received the 16.375% tax withheld in their account. Complete information is available on the DaimlerChrysler Web site.

Taxpayers applying directly to the Bundesamt need to request a letter certifying their U.S. tax status (Form 6166) from the IRS Philadelphia Service Center. IRS Publication 686, Certification for Reduced Tax Rates in Tax Treaty Countries, states that the letters normally are issued within 30 days after a request is received.

Since the 16.375% is refundable by Germany, a taxpayer who chooses not to pursue the refund cannot use that portion of the German tax in computing a foreign tax credit on the U.S. federal income tax return. However, the nonrefundable 10% German tax is eligible for the credit.

Practitioner Notes. Shareholders with DaimlerChrysler stock held in a tax deferred account, such as an IRA or 401(k) plan, should automatically receive the 16.375% tax withheld in their account. However, the remaining 10% cannot be taken as a foreign tax credit or deduction on the shareholder's personal income tax return.

Because of the unique features of the tax treaty, both the dividend amount shown in box 1 of Form 1099-DIV and the foreign tax paid shown in box 6 of Form 1099-DIV must be grossed up for Form 1040 and Form 1116 reporting purposes. The following worksheet can be used to make the adjustments:

Step 1: Compute the grossed-up dividend:

A. Enter the amount from box 1 of 1099-DIV _____

B. Multiply line A by 5.88% _____

C. Add lines A and B _____

Enter the Line C amount on Schedule B or on line 9 Form 1040. If Form 1116 is filed, also enter the Line C amount on line 1 of Form 1116.

Step 2: Compute the reportable foreign tax paid:

D. Enter the amount from Box 6 of 1099-DIV _____

E. Enter the amount from line B above _____

F. Add lines D and E _____

Enter the Line F amount on line 8 of Form 1116 (or line 43 of Form 1040 if the simplified foreign tax credit method is being used).

Example 49. A U.S. shareholder received a \$450 cash dividend in 2000. The nonrefundable German tax withheld on the dividend was 10% or \$50. Form 1099-DIV shows \$500 in box 1 and \$50 in box 6. When completing Form 1040, the reportable dividend is grossed up to \$529.40 and the deemed foreign tax paid that is eligible for the credit is \$79.40.

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Step 1: Compute the grossed-up dividend:

- A. Enter the amount from box 1 of 1099-DIV \$500.00
- B. Multiply line A by 5.88% \$ 29.40
- C. Add lines A and B \$529.40

Enter the Line C amount on Schedule B or on line 9 Form 1040. If Form 1116 is filed, also enter the Line C amount on line 1 of Form 1116.

Step 2: Compute the reportable foreign tax paid:

- D. Enter the amount from box 6 of 1099-DIV \$50.00
- E. Enter the amount from line B above \$29.40
- F. Add lines D and E \$79.40

Enter the Line F amount on line 8 of Form 1116 (or line 43 of Form 1040 if the simplified foreign tax credit method is being used).

DEDUCTION OF UNUSED INVESTMENT TAX CREDIT (I.R.C. §196)

The Tax Reform Act of 1986 generally terminated the 10% investment tax credit for property placed in service after December 31, 1985. (Exceptions applied to certain transition property.) A credit remains available for qualified rehabilitation expenses for certified historic structures and pre-1936 buildings.

Unexpired carryforwards of ITC were subjected to a 35% reduction for tax years beginning after June 30, 1987. (Calendar-year taxpayers used a 17.5% reduction for 1987.) A qualified farmer was eligible for a refundable credit on his 1987 return equal to the smallest of the following three amounts: \$750; 50% of his ITC carryover to 1987; or his net tax liability in a period beginning the year before the ITC arose and going back up to 15 years (but not earlier than 1963).

The carryforward period for business tax credits arising in 1985 was 15 years. Thus, 2000 was the final year to use carryovers of ITC arising from assets placed in service in 1985.

Practitioner Note. The Tax Relief Act of 1997 extended the carryover period for unused business tax credits to 20 years for credits arising in taxable years beginning after 1997. However, existing credit carryovers were not extended.

When an ITC was determined, the basis of the ITC property for depreciation and gain or loss on disposition was reduced by 50% of the ITC (100% for qualifying rehabilitation expenditures) unless a reduced investment credit was elected.

As compensation for the basis reduction, I.R.C. §196 provides a tax deduction in the year following the end of the carryover period for qualified business tax credits when the taxpayer has been unable to use the entire credit because of tax liability limitations. For investment tax credit (other than the rehabilitation credit), 50% of the unused credit becomes a business deduction.

A §196 deduction cannot be taken for the 35% credit reduction that was effective in 1988.

Example 50. Larry placed \$150,000 of new recovery property in service on his farm in 1985, for a \$15,000 investment tax credit. His carryover was reduced from \$10,000 to \$6,500 in 1988. Because of a variety of losses, personal credits, and AMT issues, he has been able to use only \$5,300 of the \$6,500 through 2000. Larry may deduct \$600 (1/2 of the unused \$1,200) on his 2001 Schedule F (Form 1040).

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INCOME-BASED PHASEOUTS OF SELECTED TAX BENEFITS

Tax Benefit	Refund	2001 \$ Limit	Filing Status	Income Phaseout
EIC No child One child Two or more	Yes	\$364 \$2,428 \$4,008	No MFS	\$5,950–\$10,710 \$13,100–\$28,281 \$13,100–\$32,121
Child Tax Credit	No	\$600/child	Single/HOH/QW Joint return MFS	Begins at \$75,000 Begins at \$110,000 Begins at \$55,000
Additional CTC	Yes	\$600/child	Any	Same as CTC based on filing status
Dependent Care Credit One person Two or more	No	\$720 \$1,440	Generally, no MFS*	Credit phases down from 30% at \$10,000 to 20% at \$28,000
Education Hope Credit LLC	No	\$1,500/student \$1,000/return	No MFS Single/HOH/QW Joint return	\$40,000–\$50,000 \$80,000–\$100,000
Credit for Elderly or Disabled	No	\$750 \$1,125 \$562.50	Single/HOH/QW Joint return MFS**	\$7,500–\$17,500 \$10,000–\$25,000 \$5,000–\$12,500
Adoption Credit	No	\$5,000/most \$6,000/special	No MFS	\$75,000–\$115,000
Mortgage Interest Credit	No	Generally, \$2,000***	Any	None
D.C. Homebuyer Credit	No	\$2,500 \$5,000 \$5,000	MFS Single/HOH/QW Joint return	\$70,000–\$90,000 \$70,000–\$90,000 \$110,000–\$130,000
Foreign Tax Credit	No	None	Any	None
Personal Exemptions	No	\$2,900 each	Single HOH Joint return/QW MFS	\$132,950–\$255,450 \$166,200–\$288,700 \$199,450–\$321,950 \$ 99,725–\$160,975
Itemized Deductions	No	None	MFS All others	Begins at \$66,475 Begins at \$132,950

* A married person who lived apart from his spouse during the last six months of 2001 is eligible if he paid more than half the cost of keeping up his home and the qualifying dependent lived with him for over half the year.

** MFS is eligible if spouses lived apart during entire year of 2001.

***The \$2,000 limit does not apply if credit rate is 20%.