

Chapter 2: Individual Taxpayer Problems

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Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

PROBLEM 1: UNIFORM DEFINITION OF A CHILD

There are five particular tax benefits available when a taxpayer has a **qualifying child**:

1. The dependency exemption
2. The child tax credit
3. The earned income credit (EIC)
4. The head of household (HoH) filing status
5. The child and dependent care credit

Prior to the enactment of the Working Families Tax Relief Act of 2004, the definitions of qualifying child were different for each of these benefits. Hoping to alleviate the confusion caused by the varying definitions, Congress passed one “uniform definition” for the phrase **qualifying child** that applied to each of the five tax benefits. **This became effective January 1, 2005.**

Unfortunately, the intended simplification was only partially achieved. The first complication is that each tax benefit requires that the taxpayer have a **qualifying child** and meet other requirements specific to that benefit. The second complication is that a benefit might also be available if the taxpayer has a **qualifying relative** who fails to meet the definition of **qualifying child**. The third complication is that not all relatives have to be related to the taxpayer and not all relatives are created equal under the five benefits.

Caution. These five tax benefits cannot be individually separated. They can only be broken apart to allow the noncustodial parent to claim the dependency and child tax credit. Otherwise, each qualifying individual can only be used by one taxpayer, even if the taxpayer does not qualify for all of the benefits. This is a significant change from previous years.

To determine if the taxpayer is entitled to claim any of the five tax benefits, the first step is to decide which definition fits the individual who qualifies the taxpayer for the benefit.

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Definition of Qualifying Child

To meet the definition of **qualifying child**, there are **three tests** that must be met.

1. **Residency Test.** Did the individual live with the taxpayer for more than six months of the year? Or, has the taxpayer received Form 8332, *Release of Claim to Exemption for a Child of Divorced or Separated Parent*?¹
2. **Relationship Test.** Is the individual a member of the taxpayer's immediate family? The individual must be related by blood, marriage, adoption, or she must be a foster child who was placed with the taxpayer by a qualifying agency. The individual must also be a member of the same generation as the taxpayer or a younger generation.

Note. It is no longer a requirement that the taxpayer be raising the individual as his own child.

3. **Age or Disability Test.** Is the individual under age 19, under age 24 and a full-time student, or totally and permanently disabled?

If the individual meets all **three** requirements to be a **qualifying child**, use the qualifying child chart to evaluate each of the tax benefits.

Definition of Qualifying Relative

To meet the definition of a **qualifying relative**, the individual related to the taxpayer must be a(n):

- Child or a descendent of such a child
- Brother, sister, stepbrother, or stepsister
- Father or mother, or ancestor of either
- Stepfather or stepmother
- Aunt, uncle, niece, or nephew
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law

Note. A relationship established by marriage is **not** ended by death or divorce.

If the individual is related to the taxpayer in one of these ways and does not meet the requirements to be a qualifying child, the charts for **qualifying relative** are used to evaluate each of the tax benefits.

Definition of Qualifying Other

Note. IRC §152(d) defines this individual as a **qualifying relative**, but imposes different rules for individuals who are only considered a relative if they meet this test. Therefore, for purposes of this discussion, these individuals are treated as a third group labeled **qualifying other**.

To meet the definition of a **qualifying other**, the individual must have been a member of the taxpayer's household for the **entire** tax year. **If the individual was not a member of the taxpayer's household for the entire year, none of the tax benefits are available.** If the individual was a member of the taxpayer's household for the entire year, the "Q Other" column in the qualifying relatives charts are used to evaluate the benefits.

¹ In lieu of Form 8332, the taxpayer may use a similar signed statement from the custodial parent or a court document which specifies the taxpayer will get the exemption.

Available Tax Benefits for Qualifying Children

For purposes of this table, QI = qualifying individual, and TP = taxpayer.

Tests	Only Applies to Custodial Parent				
	Dependency Exemptions	Child Tax Credit	Earned Income Credit	Child & Dependent Care Credit	Head of Household
QI age/disabled	< Age 19, 24, or disabled	< Age 17	< Age 19, 24, or disabled	< Age 13 or disabled	< Age 19, 24, or disabled
QI resides with TP	> 50% of the year, or Form 8332 or equivalent	> 50% of the year, or Form 8332 or equivalent	> 50% of the year	> 50% of the year	> 50% of the year
QI self-supporting	No	No	N/A	No	No
QI claimed as TP's dependent	N/A	N/A	N/A	If NO , allowed if TP gave exemption to other parent. See Form 2441 instructions for other exceptions	If NO , allowed if TP released dependency exemption to other parent
QI married	Cannot file joint return unless claiming refund resulting from zero tax liability	If YES , use Form 8901	No, unless claimed as dependent by TP or other parent	N/A	No, unless claimed as dependent by TP or other parent
TP pays > 50% of QI home	N/A	N/A	N/A	N/A	Yes
QI is U.S. citizen	Yes; exception for non-citizen residents of U.S., Canada, or Mexico	Yes; exception for non-citizen residents of U.S., Canada, or Mexico	N/A	Yes; exception for non-citizen residents of U.S., Canada, or Mexico	Yes; exception for non-citizen residents of U.S., Canada, or Mexico
QI is U.S. resident	N/A	N/A	Yes	N/A	N/A

Other Important Rules:

1. **Dependents cannot claim dependents.**
2. Dependents can claim Child Tax Credit using Form 8901.
3. Qualifying children cannot claim EIC.
4. Tuition deductions and credits follow dependency exemption.
5. EIC, child care credit, and HOH go together.
6. Dependency exemption and child tax credit can **only** be broken off for noncustodial parent. Otherwise, the five benefits are a **package deal** per taxpayer, whether or not all five benefits are used.

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Available Tax Benefits for Qualifying Relatives/Qualifying Others

Dependency Exemption

For purposes of this table, QI = qualifying individual, and TP = taxpayer.

Tests	Q Relative	Q Other
QI age/disabled	N/A	N/A
QI is QC of other TP	No	No
QI resides with TP	N/A	100% of the year
QI self-supporting	No	No
QI's AGI under exemption amount	Yes	Yes
QI married and filing jointly	No; cannot file joint return unless claiming refund resulting in zero tax liability	No; cannot file joint return unless claiming refund resulting in zero tax liability
QI is U.S. citizen	Yes; exception for noncitizen residents of U.S., Canada, or Mexico	Yes; exception for noncitizen residents of U.S., Canada, or Mexico
TP relationship	Family (children, siblings, parents, grandparents and above [but not foster parents], aunts/uncles, nieces/nephews, and in-laws)	Any
TP > 50% support	Yes; or multiple TPs provide > 50% support; see multiple support agreements	Yes; or multiple TPs provide > 50% support; see multiple support agreements
TP > 50% of QI home	N/A	N/A
QI and TP relationship violates local law (cohabitating, adultery, etc.)	N/A	No

Caution. Dependents may not claim others as dependents.

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Available Tax Benefits for Qualifying Relatives/Qualifying Others

Head of Household

For purposes of this table, QI = qualifying individual, TP = taxpayer, and QC = qualifying child.

Tests	Q Relative	Q Other
QI age/disabled	N/A	Does not qualify: IRC §2(b)(3)
QI is QC of other TP	No	Does not qualify: IRC §2(b)(3)
QI resides with TP	Parent does not have to live with TP; > 50% of dependent parent's home or living facility cost is paid by TP	Does not qualify: IRC §2(b)(3)
QI self-supporting	No	Does not qualify: IRC §2(b)(3)
QI's AGI under exemption amount	Yes	Does not qualify: IRC §2(b)(3)
QI married and filing jointly	No; cannot file joint return unless claiming refund resulting in zero tax liability	Does not qualify: IRC §2(b)(3)
QI is U.S. citizen	Yes; exception for noncitizen residents of U.S., Canada, or Mexico	Does not qualify: IRC §2(b)(3)
TP relationship	Family (children, siblings, parents, grandparents and above [but not foster parents], aunts/uncles, nieces/nephews, and in-laws)	Does not qualify: IRC §2(b)(3)
TP > 50% support?	Yes	Does not qualify; IRC §2(b)(3)
TP > 50% of QI home	Yes	Does not qualify: IRC §2(b)(3)
QI and TP relationship violates local law (cohabitating, adultery, etc.)	N/A	Does not qualify: IRC §2(b)(3)

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Available Tax Benefits for Qualifying Relatives/Qualifying Others Child and Dependent Care Credit

For purposes of this table, QI = qualifying individual, TP = taxpayer, and QC = qualifying child.

Tests	Q Spouse	Q Relative	Q Other
QI age/disabled	Disabled	Disabled	Disabled
QI is QC of other TP	N/A	No	No
QI resides with TP	> 50% of the year	> 50% of the year	100% of the year
QI self-supporting	N/A	No	No
QI's AGI under exemption amount	N/A	N/A	N/A
QI married and filing jointly	N/A	N/A	N/A
QI is U.S. citizen	N/A	Yes; exception for noncitizen residents of U.S., Canada, or Mexico	Yes; exception for noncitizen residents of U.S., Canada, or Mexico
TP relationship	Spouse	Family (children, siblings, parents, grandparents and above [but not foster parents], aunts/uncles, nieces/nephews, and in-laws)	Any
TP > 50% support?	N/A	Yes; or multiple TPs provide > 50% support; see multiple support agreements	Yes; or multiple TPs provide > 50% support; see multiple support agreements
TP > 50% of QI home	N/A	N/A	N/A
QI and TP relationship violates local law (cohabitating, adultery, etc.)	N/A	N/A	No

RELEASING THE DEPENDENCY EXEMPTION AND CHILD TAX CREDIT TO THE NONCUSTODIAL PARENT

Note. The Gulf Opportunity Zone Act of 2005 (GOZA) clarified the provisions shown below. Prior to its passage, changes made by the Working Families Tax Relief Act (WFTRA) were to go into effect in 2005. Retroactive to 2005, GOZA restored the requirements that were in effect prior to WFTRA.

The parent who lives with the child for the greater part of the year is the custodial parent. The other parent is the noncustodial parent. If the child did not live with the noncustodial parent for more than six months, the noncustodial parent may still claim a child's dependency exemption and related child tax credit if **all** of the following tests are met:

- The parents
 - Are divorced or separated under a decree of separate maintenance,
 - Are separated under a written separation agreement, **or**
 - Lived apart at all times during the last six months of the year.

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2. One or both of the parents provided over half of the child's total **support** for the year.
3. One or both of the parents had **custody** of the child for more than half of the year.
4. Any of the three following situations apply:
 - a. The custodial parent signs Form 8332, *Release of Claim to Exemption for Child of Divorced Parents*, or a similar statement which contains the same information required by Form 8332. The noncustodial parent **must attach** the release to his return **each year** the exemption and the child tax credit is claimed for the child.

Note. The rules for Form 8332, or similar release, apply when:

- The decree or agreement does not meet the above requirements,
- There is no decree or agreement,
- The parents were never married,
- The parents are married and separated without a decree or agreement,
- The decree or agreement is silent on the issue, or
- The custodial parent has the right to claim the child per the decree or agreement but chooses to relinquish that right to the noncustodial parent.

- b. A **post-1984** decree of divorce or separate maintenance or written separation agreement gives the noncustodial parent the **unconditional** right to claim the child as a dependent for this tax year. The decree or agreement must state:
 - ♦ That the noncustodial parent can claim the child as a dependent **without regard to any conditions** (such as payment of support),
 - ♦ That the other parent will not claim the child as a dependent, and
 - ♦ The **years** for which the claim is released.

Caution. Each year the exemption is claimed, the noncustodial parent must attach the following to the return:

- The cover page of the decree (include the custodial parent's social security number on this page),
- The pages of the decree that include all the information shown in b, and
- The signature page of the decree (with the other parent's signature and date of the agreement).

- c. A **pre-1985** decree or agreement gives the noncustodial parent the right to claim the child as a dependent for this tax year **and** the noncustodial parent pays at least \$600 of the child's support during the year. In this situation, the noncustodial parent does **not** have to attach any of the above documents.

The **January 2006** revision of **Form 8332** is shown on the following page.

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Form **8332**

(Rev. January 2006)
Department of the Treasury
Internal Revenue Service

Release of Claim to Exemption for Child of Divorced or Separated Parents

OMB No. 1545-0074

Attachment
Sequence No. **115**

▶ Attach to noncustodial parent's return each year exemption is claimed.

Name of noncustodial parent claiming exemption

Noncustodial parent's
social security number (SSN) ▶

Part I Release of Claim to Exemption for Current Year

I agree not to claim an exemption for _____
Name(s) of child (or children)

for the tax year 20____.

Signature of custodial parent releasing claim to exemption

Custodial parent's SSN

Date

Note. If you choose not to claim an exemption for this child (or children) for future tax years, also complete Part II.

Part II Release of Claim to Exemption for Future Years (If completed, see Noncustodial parent on page 2.)

I agree not to claim an exemption for _____
Name(s) of child (or children)

for the tax year(s) _____ .
(Specify. See instructions.)

Signature of custodial parent releasing claim to exemption

Custodial parent's SSN

Date

General Instructions

Purpose of form. If you are a custodial parent, you can use this form to release your claim to a dependency exemption for your child. The release of the dependency exemption will also release to the noncustodial parent the child tax credit and the additional child tax credit (if either applies). Complete this form (or a similar statement containing the same information required by this form) and give it to the noncustodial parent who will claim the child's exemption. The noncustodial parent must attach this form or a similar statement to his or her tax return each year the exemption is claimed.

You are the custodial parent if you had custody of the child for the greater part of the year. You are the noncustodial parent if you had custody for a shorter period of time or did not have custody at all.

Exemption for a dependent child. A dependent is either a qualifying child or a qualifying relative. In most cases, a child of divorced or separated parents will qualify as a dependent of the custodial parent under the rules for a qualifying child. However, the noncustodial parent may be able to claim the child's exemption if the *Special rule for children of divorced or separated parents* on this page applies.

For the definition of a qualifying child and a qualifying relative, see your tax return instruction booklet.

Post-1984 decree or agreement. If the divorce decree or separation agreement went into effect after 1984, the noncustodial parent can attach certain

pages from the decree or agreement instead of Form 8332. To be able to do this, the decree or agreement must state all three of the following.

1. The noncustodial parent can claim the child as a dependent without regard to any condition (such as payment of support).

2. The other parent will not claim the child as a dependent.

3. The years for which the claim is released.

The noncustodial parent must attach all of the following pages from the decree or agreement.

• Cover page (include the other parent's SSN on that page).

• The pages that include all of the information identified in (1) through (3) above.

• Signature page with the other parent's signature and date of agreement.



The noncustodial parent must attach the required information even if it was filed with a return in an earlier year.

Special rule for children of divorced or separated parents. A child is treated as a qualifying child or a qualifying relative of the noncustodial parent if all of the following apply.

1. The child received over half of his or her support for the year from one or both of the parents (see the *Exception* on this page). Public assistance payments, such as Temporary Assistance for Needy Families (TANF), are not support provided by the parents.

2. The child was in the custody of one or both of the parents for more than half of the year.

3. Either of the following applies.

a. The custodial parent agrees not to claim the child's exemption by signing this form or a similar statement. If the decree or agreement went into effect after 1984, see *Post-1984 decree or agreement* on this page.

b. A pre-1985 decree of divorce or separate maintenance or written separation agreement states that the noncustodial parent can claim the child as a dependent. But the noncustodial parent must provide at least \$600 for the child's support during the year. This rule does not apply if the decree or agreement was changed after 1984 to say that the noncustodial parent cannot claim the child as a dependent.

For this rule to apply, the parents must be one of the following.

• Divorced or legally separated under a decree of divorce or separate maintenance.

• Separated under a written separation agreement.

• Living apart at all times during the last 6 months of the year.

If this rule applies, and the other dependency tests in your tax return instruction booklet are also met, the noncustodial parent can claim the child's exemption.

Exception. If the support of the child is determined under a multiple support agreement, this special rule does not apply and this form should not be used.

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 13910F

Form **8332** (Rev. 1-2006)



Special rules may apply for people who had to relocate because of Hurricane Katrina, Rita, or Wilma. See Pub. 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma, for details.

Specific Instructions

Custodial parent. You may agree to release your claim to the child's exemption for the current tax year or for future years, or both.

- Complete Part I if you agree to release your claim to the child's exemption for the current tax year.
- Complete Part II if you agree to release your claim to the child's exemption for any or all future years. If you do, write the specific future year(s) or "all future years" in the space provided in Part II.



To help ensure future support, you may not want to release your claim to the child's exemption for future years.

Noncustodial parent. Attach this form or similar statement to your tax return for each year you claim the child's exemption. You can claim the exemption only if the other dependency tests in your tax return instruction booklet are met.



If the custodial parent released his or her claim to the child's exemption for any future year, you must attach a copy of this form or similar statement to your tax return for each future year that you claim the exemption. Keep a copy for your records.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

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 Internal Revenue Code section 6103.

The average time and expenses required to complete and file this form will vary depending on individual circumstances. For the estimated averages, see the instructions for your income tax return.

If you have suggestions for making this form simpler, we would be happy to hear from you. See the instructions for your income tax return.

AN INDIVIDUAL WHO IS A QUALIFYING PERSON FOR MORE THAN ONE TAXPAYER

There are times when an individual is a qualifying person for more than one taxpayer. Except as discussed previously under "Releasing the Dependency Exemption to the Other Parent," the tax benefits associated with the qualifying individual can only be claimed by one taxpayer. However, the taxpayers may decide among themselves who will claim the benefits.

Example 1. Jolene and her daughter, Sandy, live with Jolene's mother, Dolly, in 2006. Dolly earns \$20,000 in 2006 and provides over half the cost of keeping up the home for the family. Jolene is 36 and has \$4,000 in 2006 wages. Sandy is only 8 years old in 2006. Sandy meets all the tests to be Jolene's qualifying child. Sandy **also** meets all the tests to be Dolly's qualifying child.

Jolene doesn't qualify as head of household (HoH) for 2006. Dolly qualifies as HoH and all of the tax benefits increase her 2006 refund. Therefore, Dolly and Jolene decide that Dolly will use Sandy as a qualifying child on her 2006 return. Jolene will **not** qualify for the earned income credit (EIC) related to Sandy because she allowed Dolly to use Sandy as a qualifying child. However, Jolene will qualify for a lesser amount of 2006 EIC under the rules for taxpayers without qualifying children.

When taxpayers **cannot agree**, the following **tiebreaker rules** apply:

- Is one taxpayer the individual's parent? The parent wins the tiebreaker.
- If both taxpayers are the individual's parents, the taxpayer with custody for the greater part of the year wins.
- If neither had custody for more time than the other, the one with the highest AGI wins the tiebreaker.
- If neither taxpayer is the individual's parent, the taxpayer with the highest AGI wins the tiebreaker.

Example 2. Use the same facts as **Example 1**. Jolene decides that she wants the tax benefit of the 2006 EIC for Sandy. Therefore, she files her 2006 return and claims Sandy as her qualifying child for EIC purposes. Under the tiebreaker rules, Dolly loses Sandy's exemption, HoH status, the child tax credit, the child care credit, and the EIC she would have received for 2006. Jolene, the parent of Sandy, wins under the tiebreaker rules.

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The following is an excerpt from IRS Pub. 501, *Exemptions, Standard Deduction and Filing Information*.

Table 6. **When More Than One Person Files a Return Claiming the Same Qualifying Child (Tie-Breaker Rule)**

Caution. If a child is treated as the qualifying child of the noncustodial parent under the rules for children of divorced or separated parents, see *Applying this special test to divorced or separated parents*.

IF more than one person files a return claiming the same qualifying child and . . .	THEN the child will be treated as the qualifying child of the . . .
only one of the persons is the child's parent,	parent.
two of the persons are parents of the child and they do not file a joint return together,	parent with whom the child lived for the longer period of time during the year.
two of the persons are parents of the child, they do not file a joint return together, and the child lived with each parent the same amount of time during the year,	parent with the highest adjusted gross income (AGI).
none of the persons are the child's parent,	person with the highest AGI.

FACTUAL SCENARIOS

The taxpayers in the following scenarios are citizens and residents of the United States. For each taxpayer in the following scenarios, the tax result shows:

- Filing status,
- EIC available,
- Number of exemptions, and
- Number of qualifying children for the child tax credit.

Scenario 1. Eldon is 46 and has \$17,000 of 2006 wages. His spouse, Ellen, is 52 and has \$8,000 of 2006 wages. Their son, Elway, is 14 years old, and lives with them the entire year. He has no income in 2006.

Tax Result 1. Eldon and Ellen should file married filing jointly (MFJ). Since Elway meets the residency, relationship, and age tests, he is their qualifying child. He is not self-supporting or married. They can claim Elway as a dependent and use him for EIC purposes. They are entitled to three exemptions, and one qualifying child for the child tax credit.

Scenario 2. Pat and Chris are married with two children, Sam and Joan. Sam, who is age 20, is a full-time college student with \$20,000 of 2006 wages. Sam uses his parents' address as his permanent address. He supports himself in 2006. Joan, who is a 16-year-old high school student, has 2006 wages of \$5,000. Pat and Chris have a 2006 AGI of \$300,000.

Tax Result 2. Pat and Chris should file MFJ. They cannot claim Sam's exemption because Sam provides over half of his own support. They can claim Joan. However, because their AGI is \$300,000, they lose partial benefit of their total 2006 exemptions. **Before reduction,** their exemptions total \$9,900 ($\$3,300 \times 3$). **After the reduction,** their allowable total exemption amount is \$5,940 ($\$1,980 \times 3$), assuming they claim Joan's exemption. They also cannot claim any child tax credit for Joan due to their high AGI.

In this situation, Joan is a **qualified child** for **both** her parents and for Sam. Joan lives in the same home with Sam. Sam's time away at school is considered temporary. Joan is Sam's sibling and she is under age 19 in 2006. Therefore, Sam may claim Joan's \$3,300 exemption on his 2006 return. He may also claim a \$1,000 child tax credit for Joan. Sam may **not** claim EIC for Joan because he is still a **qualifying child** of his parents. Sam's 2006 filing status is single. He does not qualify for HoH because he did not pay over half the cost of keeping up the home in 2006.

Observations for Scenario 2

1. The tax result for Scenario 2 was not possible in 2004. It is possible for 2005 and 2006 unless retroactive legislation is passed to prevent it.
2. Practitioners with high-income clients whose 2005 factual situation is similar to that shown in Scenario 2 may want to file amended returns to take advantage of the law change.
3. If Sam was **not** a college student in 2006, but still lived in his parents' home, **he would no longer be a qualifying child of his parents.** As such, he could claim the dependency, the child tax credit, and EIC.
4. Scenario 2 shows clearly an unintended tax benefit for high-income families due to the uniform definition of a child rules which became effective in 2005.
5. The Bush administration asked Congress to address this unintended tax benefit with preventive legislation. It is reasonably anticipated that the legislation will eventually become law. If it does, it could be retroactive to 2006 tax returns.

Scenario 3. Mom and Dad provide a home for their two children, Karla and Roger, in 2006. Mom and Dad's sole income is from social security benefits and they do not file a tax return. Karla is 27 years old, earns \$15,000 a year as a full-time employee, and spends most of her money on clothes and cosmetics. Roger is 17 years old, earns \$2,000 a year, and spends most of his money on video games.

Tax Result 3. Mom and Dad do not file a 2006 tax return. Karla does not pay over half of the costs of the home, so she does not qualify as HoH. However, her brother, Roger, meets the residency, relationship, and age requirements to be a **qualifying child** of Karla's. Karla is too old to be anyone else's **qualifying child** and her income is too high to be a dependent. Since Roger does not provide over half of his own support, Karla may claim him as a dependent. Roger is too old for her to claim the child tax credit and dependent care credit. However, Karla may use Roger to claim 2006 EIC for him as her **qualifying child**.

Scenario 4. In 2006, Bubba and Charlene live together in a relationship that is not recognized as a common-law marriage and is not in violation of local law. Charlene's 3-year-old child, Junior, lives with Bubba too. Junior's dad is Billy. Bubba kept up the home and supported Charlene and Junior in 2006. Charlene has \$2,000 of 2006 wages. They paid \$300 for 2006 day care expenses while Charlene worked.

Tax Result 4. Bubba must file as single. Junior is not related to Bubba, so he is not Bubba's **qualifying child**. Because Junior is **Charlene's qualifying child**, Bubba cannot claim him under the rules for qualifying other relatives. However, under the same rules, Bubba can claim Charlene as an exemption.

Charlene also must file as single. Although Junior is her **qualifying child**, she did not pay over half the costs of the home. Therefore, Charlene does not qualify for HoH. She cannot claim the dependency exemption for Junior because Bubba can claim Charlene as a dependent, and dependents of other taxpayers are not allowed to claim any exemptions. Charlene does qualify for the child tax credit and dependent care credit for Junior, but her 2006 income is too low for her to benefit from them. She does qualify for EIC related to Junior.


Bubba and Charlene thought it would be nice to let Billy claim Junior's exemption, since neither of them could. However, since Bubba (not Charlene or Billy) supports Junior, Billy does not qualify to claim Junior's exemption.

Scenario 5. Uncle Jed housed and supported his niece, Daisy, from January through August 2006. Daisy, age 16, had no 2006 income. In September 2006, she ran off with Bo and got married. Bo earned \$30,000 in 2006 and does not want to file separately.

Tax Result 5. Uncle Jed must file as single, even though Daisy meets the residency, relationship, and age tests to be his **qualifying child**. Jed cannot claim HoH because Daisy is married and files a joint 2006 return. Jed cannot claim her as a dependent for the same reason. Because she is married, Jed must be able to claim her as a dependent in order for him to use her for EIC purposes, so he loses that as well. However, he may claim the 2006 child tax credit for her by completing Form 8901, *Information on Qualifying Children Who Are Not Dependents (For Child Tax Credit)*.

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For Scenario 5

Form 8901	Information on Qualifying Children Who Are Not Dependents (For Child Tax Credit)		OMB No. 1545-0074 2006 Attachment Sequence No. 59
Department of the Treasury Internal Revenue Service (99)		Complete and attach to Form 1040, Form 1040A, or Form 1040NR.	
Name(s) shown on return Uncle Jed		Your social security number 222 22 2222	



- Do not use this form for any child who is claimed as your dependent on Form 1040A or Form 1040, line 6c, or Form 1040NR, line 7c.
- It will take us longer to process your return and issue your refund if you do not complete all columns for each qualifying child.
- Be sure the child's name and social security number (SSN) agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your child tax credit. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information

	(a) First name	Last name	(b) Child's social security number	(c) Child's relationship to you (son, daughter, etc.)
Child 1	Daisy	Young	777 77 7777	Niece
Child 2				
Child 3				
Child 4				

General Instructions

Purpose of Form

Use Form 8901 to give the IRS information on any qualifying child (defined on back) who is not your dependent. To figure the amount of your child tax credit, see the instructions for Form 1040A, line 33, or Form 1040, line 52.

Who Must File

Use Form 8901 if your qualifying child is not your dependent because either of the following applies.

- You, or your spouse if filing jointly, can be claimed as a dependent on someone else's 2006 return.
- Your qualifying child is married and files a joint return for 2006 (unless that joint return is filed only as a claim for a refund and no tax liability would exist for either spouse if they had filed separate returns).

Specific Instructions

Column (b)

If your child was born and died in 2006 and you do not have an SSN for the child, you can attach a copy of the child's birth certificate instead and enter "Died" in column (b).

If you do not have an SSN for your adopted child, enter "See page 2" in column (b). Then, on the bottom of page 2, enter the name and address of any agency or agent (such as an attorney) that assisted in the adoption.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

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 Internal Revenue Code section 6103.

The average time and expenses required to complete and file this form will vary depending on individual circumstances. For the estimated averages, see the instructions for your income tax return.

If you have suggestions for making this form simpler, we would be happy to hear from you. See the instructions for your income tax return.

Qualifying Child for Child Tax Credit

A **qualifying child** is a child who is your . . .

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was . . .

Under age 17 at the end of 2006

AND

who . . .

Did not provide over half of his or her own support for 2006 (see Pub. 501)

AND

who . . .

Lived with you for more than half of 2006. If the child did not live with you for the required time, see *Exception to time lived with you* on page 23 of the Form 1040A instructions or page 21 of the Form 1040 instructions.

AND

who . . .

Was a U.S. citizen, U.S. national, or a resident of the United States. If the child was adopted, see *Exception to citizen test* on page 23 of the Form 1040A instructions or page 21 of the Form 1040 instructions.



For more information, including definitions and special rules relating to an adopted child, foster child, and qualifying child of more than one person, see the instructions for Form 1040A or Form 1040, line 6c.

Scenario 6. Zsa Zsa is an unmarried mother who pays 100% of the costs of the home and support for herself and her two sons, ages 11 and 14. Zsa Zsa signed Form 8332 to waive her right to claim the exemption of her 14-year-old son, and gave the form to his father.

Tax Result 6. Zsa Zsa should file as HoH. **Both** children are **qualified children** for purposes of EIC. She can claim an exemption for herself and the 11-year-old son, and the child tax credit for him.

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Scenario 7. Tom is age 25, is unmarried, and has wages of \$8,900 in 2006. He provides a home for his sister, Theresa, who is age 27. She is single and has \$2,350 of wages in 2006. Tom provides over half of her support for the year. Theresa lived with Tom for all 12 months. No one else provided any support for either of them.

Tax Result 7. Theresa is not Tom's **qualifying child** because she is too old. However, as shown on the **qualifying relatives** charts, she meets the tests for Tom to file as HoH and to claim her as a dependent. Although Theresa does not qualify Tom for EIC, he is entitled to a small amount of 2006 EIC using the EIC table for no qualifying children.

Scenario 8. Shelly Marsh, a 22-year-old full-time college student, has \$16,000 of wages in 2006. She is raising her 16-year-old brother, Stan, since their parents died in a freak cow stampede in 2005.

Tax Result 8. Stan is Shelly's **qualifying child** because he meets the age, residency, and relationship tests. However, because Shelly is a full-time student under age 24, she is also a **qualifying child** of Stan's. Therefore, Shelly cannot claim EIC in 2006. On her 2006 return, Shelly can:

- File as HoH,
- Claim Stan as a dependent, and
- Claim the \$1,000 child tax credit for Stan.

Scenario 9. Mom has an unmarried daughter, Paris, who is 16 years old and who lived with Mom for all 12 months of 2006. Paris has a baby, Nicole, who also lived with them the whole year. Neither Paris nor the baby had any income in 2006. Mom had \$24,000 of wages in 2006 and received \$40,000 in child support from Paris' father. Mom provided the home and support for Paris and Nicole from these funds. Paris' father, Mom's ex-husband, wanted to claim the dependency exemptions for Paris and the baby for 2006, but the divorce decree is silent on the issue.

Tax Result 9. Mom can file as HoH because **both** Paris and the baby are **qualifying children** for her. They are also **qualifying children** for EIC purposes. The child support was not taxable to Mom, so her \$24,000 of earned income is still low enough for EIC.

As the custodial parent, Mom controls the dependency exemption for Paris. She may release the exemption and the related child tax credit to Paris' father if she chooses. However, she may not release Nicole's exemption and child tax credit to him, because he is not one of Nicole's parents.

Scenario 10. Continuing the saga of Paris from **Scenario 9**, the baby's father, Donald, made \$10,000 in 2006 and wants to claim the baby and all of the related tax benefits. Donald lived alone in 2006.

Tax Result 10. Since Donald and Paris did not provide over half of Nicole's support in 2006, no one can release her exemption and child tax credit to Donald. Since Nicole did not live with Donald for over half of 2006, he is not entitled to claim the EIC, any dependent care credit, or HoH filing status for 2006.

Scenario 11. Chacha is age 27 and single, and has not had a job in years. She lived with her new boyfriend Chunk, age 22, for seven months in 2006. Chunk earned \$10,500 of wages in 2006.

Tax Result 11. Chunk must file as single. Since Chacha is not related to him and did not live with him for the entire year, he cannot claim her as a dependent. She does not qualify him for any other 2006 tax benefits since Chacha is not a **qualified relative**.

Scenario 12. In 2004, Chacha lived with her boyfriend Hunk for the entire year. Hunk had 2004 wages of \$24,000 and also had \$500 of taxable interest income.

Tax Result 12. Hunk filed as single for 2004. He did not qualify for HoH because Chacha was not related to him. He claimed his own exemption and Chacha's, because she met all of the tests for a **qualifying other** relative in 2004.

Scenario 13. Edgar is age 52 and unmarried. He has \$50,000 of wages in 2006. His daughter Edwina is 22 years old and has \$10,000 of 2006 wages. Edwina and her 2-year-old son, Max, live with Edgar in his home for all of 2006. Edwina was not a full-time student. Max's 2006 day care expenses while Edgar and Edwina were at work are \$2,000.

Tax Result 13. Max is a **qualifying child** of Edgar's. Consequently, Edgar may file as HoH, **if** Edwina lets him. As Max's parent, she wins the tiebreaker rules if both she and Edgar want to claim Max's as a **qualifying child**. If she allows it, Edgar may claim Max's exemption and the related child tax credit. He may also claim the dependent care credit on Form 2441, *Child and Dependent Care Expenses*. However, his earned income is too high to qualify for EIC.

If Edgar claims Max on his return, Edwina must file as single and claim only her own personal exemption.

However, if Edwina chooses to claim Max on her return, Edgar must file as single and he loses Max's exemption, the child tax credit, and the dependent care credit. Edwina can claim Max as a dependent even though she did not provide over half of his support. She also benefits from the child tax credit, the EIC, and the dependent care credit. However, she does not qualify as HoH since Edgar paid for the home expenses.

Scenario 14. Assume Edwina in **Scenario 13** was a full-time student in 2006 and that she did not provide over half of her own support.

Tax Result 14. Edwina is now a **qualifying child** of Edgar's. He may use her to qualify for HoH and he may claim her exemption and education credits, in addition to Max's tax benefits.

Edwina cannot claim Max as a dependent because individuals who can be claimed as dependents of other taxpayers are not allowed to claim dependents. She also cannot claim EIC because a taxpayer who is a **qualifying child** of another cannot claim EIC. However, if she wanted to **force the issue**, she could still claim the child tax credit and dependent care credit for Max, although this would bar Edgar from any of the tax benefits related to Max. Edwina would use Form 8901, *Information on Qualifying Children Who Are Not Dependents (For Child Tax Credit)*, to claim the child tax credit.

Scenario 15. Assume Edwina in **Scenario 14** was a full-time student who **provided over half of her own support**.

Tax Result 15. Edwina is still a **qualifying child** of Edgar's. However, since she provides over half of her own support, Edgar cannot claim her as a dependent or use her to qualify for HoH status. She may not claim EIC for Max because she is a **qualifying child of Edgar's**, but she can claim Max's exemption, child tax credit, and dependent care credit.

Scenario 16. Rocky is single, age 24, and earns \$11,000 in 2006. Rocky's girlfriend, Maggy, is 21 years old. She has a 2-year-old daughter, Lisa (not Rocky's), who lives with Rocky the entire year. Maggy has \$4,000 of 2006 wages.

Tax Result 16. Rocky must file as single because neither Maggy nor Lisa is related to him. He cannot claim Maggy as a dependent because she earned over \$3,300 in 2006. He cannot claim Lisa as a dependent because she is a **qualifying child** of Maggy's. He also does not qualify for the child tax credit. Having no qualifying children, Rocky cannot claim any of the other tax benefits.

Scenario 17. Use the same facts as in **Scenario 16**, except Lisa was placed in Rocky's home by a state agency.

Tax Result 17. Because Lisa was placed with Rocky by a state agency, she is now a **qualified foster child** of Rocky's and is considered to be his child. He can claim her exemption, the child tax credit, EIC, HoH, and any dependent care expenses. If Maggy decides to claim Lisa on her tax return, she will **not** win the tiebreaker test since both parties are considered parents, and Rocky's 2006 AGI is higher. Since Rocky and Maggy lived together for the entire year, they cannot split the dependency and child tax credit from the other benefits.

2006 Workbook

Scenario 18. Barney is 52 years old and earns \$20,000 in 2006. His wife Birdie is age 59 and earns \$36,000. Their son Bob, a part-time slacker, is age 22 and earns \$4,000 in 2006 wages. Their daughter, Babs, is a 16-year-old high school student who has no income in 2006. They all live together in a big blue house.

Tax Result 18. Barney and Birdie should file MFJ. They cannot claim Bob as a dependent because he earns over \$3,300 in 2006. However, they can claim Babs' exemption and her \$1,000 child tax credit. Their earned income is too high for EIC and Babs is too old for the dependent care credit, unless she is disabled.

Scenario 19. Mr. Big Heart is age 50, single, and earns \$70,000 in 2006. His mother is in a nursing home and received \$8,500 of social security and \$1,000 of taxable interest income. Mr. Big Heart paid \$30,000 in 2006 to the nursing home for her support.

Tax Result 19. Mr. Big Heart can file as HoH. Mom meets the tests to be claimed as a dependent since her AGI is only \$1,000 and Big Heart provides over half of her support. As a dependent parent, Mom does not have to live with her son in order to qualify him as HoH.

Scenario 20. Milly is age 48 and has \$19,000 of 2006 wages. Her husband passed away in 2004. In 2006, she supports her 10-year-old son and her father, who both live with her. Her father, Willy, is 73 years old and has 2006 wages of \$7,000 as a Wal-Mart greeter.

Tax Result 20. Milly can file as a qualifying widow. She may claim her son since he is a **qualifying child**, but she cannot claim her father as a dependent because his gross income is not less than the personal exemption amount (\$3,300 for 2006).

Scenario 21. Mr. Crab is age 47 in 2006 and a widower. Mr. Crab has \$22,000 of wages and \$2,900 of interest income in 2006. His son Bob, age 30, did not live with him. However, Mr. Crab provides more than half of Bob's support. Bob earns \$4,300 flipping seafood burgers in 2006.

Tax Result 21. Mr. Crab must file as single. He cannot claim Bob as a dependent because Bob's 2006 gross income is not less than \$3,300. Because Bob did not live with him, he cannot claim HoH.

Scenario 22. Elton earned \$112,000 in wages last year. His friend Lawrence, age 36, lived with him all year. Their relationship did not violate any local laws. Lawrence earned \$2,500 in wages.

Tax Result 22. Elton must file as single. He may claim Lawrence as a dependent, but since they are not related, Lawrence does not qualify him for HoH.

PROBLEM 2: ALTERNATIVE MINIMUM TAX

Note. See the 2004 *University of Illinois Federal Tax Workbook*, Chapter 8, *Alternative Minimum Tax (AMT)*, for detailed step-by-step instructions for calculating AMT.

BACKGROUND INFORMATION

Preliminary Statistics for the 2004 Tax Year.² The chart below compares the impact of AMT on individual tax returns for the 2003 and 2004 tax years.

Tax Year	Number of Returns Reporting AMT Liability	Amount of AMT Reported
2003	2.379 million	\$ 8.7 billion
2004	3.133 million (31.7% increase)	\$12.1 billion (38.1% increase)

² "Winter 2005–2006 Statistics of Income Bulletin" found in IR-2006-55, April 7, 2006

2006 Workbook

Of the total \$12.1 billion of AMT reported on 2004 tax returns, 96% (\$11.6 billion) was paid by taxpayers who reported 2004 AGIs of \$100,000 or more. However, as the following chart demonstrates, the lowest income taxpayers, those with 2004 AGIs under \$15,000, reported the highest average 2004 AMT liability.

2004 AGI	Under \$15,000	\$15,000–29,999	\$30,000–49,999
Average AMT	\$6,954	\$2,061	\$1,283
2004 AGI	\$50,000–99,999	\$100,000–199,999	\$200,000 or more
Average AMT	\$1,403	\$1,853	\$5,498

Increased 2006 AMT Exemption Amounts. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) increased the 2006 AMT exemption amounts as shown in the following chart.

Tax Year	Married Filing Jointly and Surviving Spouse	Single and Head of Household	Married Filing Separate
2005	\$58,000	\$40,250	\$29,000
2006	62,550	42,500	31,275

2006 AMT Exemption AMTI³ Phaseout Ranges

Tax Year	Married Filing Jointly and Surviving Spouse	Single and Head of Household	Married Filing Separate
2005	\$150,000–382,000	\$112,500–273,500	\$75,000–191,000
2006	150,000–400,200	112,500–282,500	75,000–200,100

In addition, TIPRA extended current law by allowing most nonrefundable personal tax credits to be claimed against both 2006 regular and AMT liability. **As a result, individual taxpayers continue to receive the full benefit of the following 2006 personal tax credits:**

- Child and dependent care credit (Form 2441)
- Credit for the elderly or the disabled (Schedule R)
- Child tax credit (Form 8901, if required)
- Education credits (Form 8863)
- Adoption credit (Form 8839)
- Retirement savings contribution credit (Form 8880)
- Mortgage interest credit (Form 8396)
- Energy tax credits (New in 2006. Created by the Energy Policy Act of 2005.)
- Alternative motor vehicles (New in 2006. Created by the Energy Tax Incentives Act of 2005.)

Note. The AMT provisions of TIPRA are anticipated to prevent an estimated 15 million taxpayers from owing AMT in 2006.

³. AMTI stands for Alternative Minimum Taxable Income, which is shown on line 28 of Form 6251.

2006 Workbook

Congress is aware of the looming AMT crisis and has repeatedly taken steps to provide temporary relief to taxpayers. Raising the 2006 AMT exemption amounts is the latest example of congressional attempts to deal with the AMT crisis.

As shown in the chart at the beginning of “Problem 2: Alternative Minimum Tax,” the AMT provision raised over \$12 billion of tax revenue on 2004 individual tax returns. Although the amount of AMT tax revenue reported on 2005 individual tax returns is currently not known, it is assumed that the 2005 AMT figure is even higher. The number of taxpayers who owed 2005 AMT is estimated to be between 4 million and 12.7 million.

The dilemma for Congress is how to replace AMT revenue in an era of mushrooming federal budget deficits. Furthermore, absent either a complete repeal of AMT or a significant increase in the AMT exemption amounts, the tax revenue generated by the AMT will grow dramatically in future years. Even though the increases to the 2006 AMT exemption amounts are relatively small, the result is that fewer taxpayers will have AMT liability on their 2006 tax returns. Based on historical patterns, it is expected that Congress will continue to apply a “Band-Aid” approach to the growing AMT crisis in future years.

NEW AMT CALCULATOR AVAILABLE ON IRS WEBSITE

The IRS introduced an online tool called **AMT Assistant** to help taxpayers and others quickly determine if an AMT liability exists. This tool was available for 2005 individual tax returns. The following is an excerpt from the IRS website:

Every year taxpayers need to consider whether they will have to pay the Alternative Minimum Tax (AMT). The AMT Assistant is intended to provide a simple test for taxpayers who fill out their tax returns without using software to determine whether they may be subject to the AMT.

The AMT Assistant is an electronic version of the AMT Worksheet in the Form 1040 Instructions, called the “Worksheet to See if You Should Fill in Form 6251 — Line 45.”

Using the AMT Assistant. *The AMT Assistant is easy to use. You just answer a few simple questions about entries on your draft 1040 and the system does the rest. You will see the results immediately on your computer screen. Based on your entries, the results tell you either you do not owe the AMT or that you must go further and fill out Form 6251 to find out if you owe the AMT.*

The Assistant can be used by individuals, tax practitioners and community or public service organizations.

Caution. Although the online tool is quick and simple for taxpayers to use, it does not provide accurate results if taxpayers have AMT adjustment and preference items such as:

- Incentive stock options
- Interest on home equity loans
- Accelerated depreciation
- Interest from private activity bonds exempt from regular tax

Although the IRS can help taxpayers who manually prepare their own returns, sophisticated tax preparation software programs provide better results. Computing the 25 adjustments/preferences in Part I of Form 6251, *Alternative Minimum Tax — Individuals*, in some instances can be a time-consuming chore even for experienced tax practitioners who utilize tax preparation software.

COMMON AMT TRAPS

Taxpayers who have the following **AMT adjustments or preference items** are the most likely to owe AMT:

1. High state and local taxes
2. Unreimbursed employee business expenses
3. Large net capital gains
4. Home mortgage interest
5. Personal exemptions
6. Incentive stock options (ISOs)
7. Investment interest
8. Contingent attorney fees

High State and Local Taxes. All state and local taxes, including optional state sales taxes deducted on line 9 of Schedule A for regular tax purposes, are not allowed for AMT purposes. **These taxes are added back on line 3 on Form 6251.** Taxpayers who reside in states that impose high state income taxes are more likely to owe AMT.

Example 3. Tom resides in Connecticut and claims \$10,000 of state income tax and \$15,000 of real estate taxes on his **2006** Schedule A. The total of \$25,000 must be entered on line 3 on his **2006** Form 6251. Depending on other facts, Tom may or may not be liable for AMT in **2006**.

Unreimbursed Employee Business Expenses. All miscellaneous itemized deductions, including employee business expenses reported on Form 2106, *Employee Business Expenses*, are not allowed for AMT purposes. **These deductions are added back on line 5 of Form 6251.** Salaried sales representatives and others who frequently incur unreimbursed employee business expenses could owe AMT.

Example 4. Melinda, who is single, is a commissioned sales representative who receives no reimbursement from her employer for her employee business expenses. Consequently, she deducts \$77,860 on line 20 of her **2006** Schedule A as unreimbursed employee expenses from Form 2106. After subtracting 2% of her AGI, she claims \$75,000 on line 26, Schedule A. She also deducts \$9,000 of taxes on line 9 and \$14,000 of charitable contributions on line 15.

AGI (W-2 wages of \$142,300 + \$700 state income tax refund)	\$143,000
Itemized Deductions (\$75,000 + \$9,000 + \$14,000)	(98,000)
Form 1040, line 41	\$ 45,000
Exemption (herself only)	(3,300)
Taxable income	\$ 41,700
Regular tax from tax tables	\$ 6,989
AMT from the 2006 Form 6251 (shown on the next page)	\$ 16,346
Total tax liability	\$ 23,335

Planning Suggestion. In order to lower her overall federal tax liability, it might be wise for Melinda and her employer to agree to reduce her commission percentage in exchange for reimbursement of some of her employee business expenses.

2006 Workbook

For Example 4

Form 6251 (Rev. January 2006) Department of the Treasury Internal Revenue Service (99)	<h3 style="margin: 0;">Alternative Minimum Tax—Individuals</h3> <p style="margin: 0;">▶ See separate instructions.</p> <p style="margin: 0;">▶ Attach to Form 1040 or Form 1040NR.</p>	OMB No. 1545-0074 <div style="text-align: center; font-size: 2em; font-weight: bold; margin: 5px 0;">2006</div> Attachment Sequence No. 32																		
Name(s) shown on Form 1040 Melinda		Your social security number 888 : 88 : 8888																		
Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)																				
1 If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 2), and go to line 2. Otherwise, enter the amount from Form 1040, line 38 (minus any amount on Form 8914, line 2), and go to line 7. (If less than zero, enter as a negative amount.)	1	45,000																		
2 Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4, or 2½% of Form 1040, line 38	2																			
3 Taxes from Schedule A (Form 1040), line 9	3	9,000																		
4 Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions	4																			
5 Miscellaneous deductions from Schedule A (Form 1040), line 26	5	75,000																		
6 If Form 1040, line 38, is over \$150,500 (over \$75,250 if married filing separately), enter the amount from line 9 of the Itemized Deductions Worksheet on page A-9 of the Instructions for Schedules A & B (Form 1040)	6	()																		
7 Tax refund from Form 1040, line 10 or line 21	7	(700)																		
8 Investment interest expense (difference between regular tax and AMT)	8																			
9 Depletion (difference between regular tax and AMT)	9																			
10 Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10																			
11 Interest from specified private activity bonds exempt from the regular tax	11																			
12 Qualified small business stock (7% of gain excluded under section 1202)	12																			
13 Exercise of incentive stock options (excess of AMT income over regular tax income)	13																			
14 Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	14																			
15 Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15																			
16 Disposition of property (difference between AMT and regular tax gain or loss)	16																			
17 Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	17																			
18 Passive activities (difference between AMT and regular tax income or loss)	18																			
19 Loss limitations (difference between AMT and regular tax income or loss)	19																			
20 Circulation costs (difference between regular tax and AMT)	20																			
21 Long-term contracts (difference between AMT and regular tax income)	21																			
22 Mining costs (difference between regular tax and AMT)	22																			
23 Research and experimental costs (difference between regular tax and AMT)	23																			
24 Income from certain installment sales before January 1, 1987	24	()																		
25 Intangible drilling costs preference	25																			
26 Other adjustments, including income-based related adjustments	26																			
27 Alternative tax net operating loss deduction	27	()																		
28 Alternative minimum taxable income. Combine lines 1 through 27. (If married filing separately and line 28 is more than \$191,000, see page 7 of the instructions.)	28	128,300																		
Part II Alternative Minimum Tax																				
29 Exemption. (If this form is for a child under age 14, see page 7 of the instructions.)																				
<table style="margin: auto; border: none;"> <tr> <td style="width: 30%;"></td> <td style="width: 30%; text-align: center;">AND line 28 is not over . . .</td> <td style="width: 30%; text-align: center;">THEN enter on line 29 . . .</td> <td></td> </tr> <tr> <td>IF your filing status is . . .</td> <td></td> <td></td> <td></td> </tr> <tr> <td>Single or head of household</td> <td style="text-align: right;">\$112,500</td> <td style="text-align: right;">\$42,500</td> <td rowspan="3" style="font-size: 3em; vertical-align: middle;">}</td> </tr> <tr> <td>Married filing jointly or qualifying widow(er)</td> <td style="text-align: right;">150,000</td> <td style="text-align: right;">62,550</td> </tr> <tr> <td>Married filing separately</td> <td style="text-align: right;">75,000</td> <td style="text-align: right;">31,275</td> </tr> </table>		AND line 28 is not over . . .	THEN enter on line 29 . . .		IF your filing status is . . .				Single or head of household	\$112,500	\$42,500	}	Married filing jointly or qualifying widow(er)	150,000	62,550	Married filing separately	75,000	31,275	29	38,550
	AND line 28 is not over . . .	THEN enter on line 29 . . .																		
IF your filing status is . . .																				
Single or head of household	\$112,500	\$42,500	}																	
Married filing jointly or qualifying widow(er)	150,000	62,550																		
Married filing separately	75,000	31,275																		
If line 28 is over the amount shown above for your filing status, see page 7 of the instructions.																				
30 Subtract line 29 from line 28. If zero or less, enter -0- here and on lines 33 and 35 and stop here	30	89,750																		
31 • If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 55 here. • All others: If line 30 is \$175,000 or less (\$87,500 or less if married filing separately) multiply line 30 by 26% (.26) . Otherwise, multiply line 30 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result.	31	23,335																		
32 Alternative minimum tax foreign tax credit (see page 7 of the instructions)	32	0																		
33 Tentative minimum tax. Subtract line 32 from line 31	33	23,335																		
34 Tax from Form 1040, line 44 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 47). If you used Schedule J to figure your tax, the amount for line 44 of Form 1040 must be refigured without using Schedule J (see page 9 of the instructions)	34	6,989																		
35 Alternative minimum tax. Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35	16,346																		

For Paperwork Reduction Act Notice, see page 9 of the instructions.

Cat. No. 13600G

Form **6251** (2006) (Rev. 1-2006)

2006 Workbook

Large Net Capital Gains. Even though long-term capital gains are neither an adjustment nor a preference item that must be entered on Form 6251, their presence can produce AMT liability. This is especially true for high-income taxpayers. **The main reason for this is that the AMT exemption is phased out for taxpayers with high alternative minimum taxable incomes (AMTIs).**

Example 5. Gary's 2006 AGI of \$110,000 does not include a contemplated sale of land. He is single, under age 65, and does not itemize for 2006. He has no AMT adjustment or preference items in 2006. As a result, Gary's total 2006 tax liability is **\$22,766** as shown in the following chart.

Regular tax from tax rate schedule for single taxpayers (taxable income of \$101,550)	\$22,766
Tentative minimum tax on AMTI of \$110,000 (line 33, Form 6251: not shown)	17,550
Alternative minimum tax (line 35, Form 6251: not shown)	0

Result. Gary's total 2006 tax liability is \$22,766, consisting entirely of regular tax. Since his regular tax exceeds his tentative minimum tax, he owes no AMT and does not attach Form 6251 to his 2006 tax return.

Example 6. Gary does sell his land in December 2006 and realizes a \$200,000 long-term capital gain on the sale. He receives the entire sales price of \$500,000 in 2006. Gary's 2006 taxable income for regular tax purposes is now \$303,750 as shown below.

AGI (including the \$200,000 long-term capital gain on the sale of the land)	\$310,000
Less: standard deduction	(5,150)
Less: exemption (reduced by the 2006 AGI phaseout rules: 1/3 of \$3,300)	(1,100)
Gary's 2006 taxable income for regular tax purposes	\$303,750

Gary's regular 2006 tax liability on \$303,750 of taxable income is \$53,382 as shown below.

\$200,000 long-term gain × 15%	\$30,000
Tax on the remaining \$103,750 of taxable income from tax rate schedule	23,382
	\$53,382

Gary's total 2006 tax liability is **\$58,600**.

Regular tax	\$53,382
AMT (line 35, Form 6251)	5,218
Gary's total 2006 tax liability including AMT	\$58,600

2006 Workbook

For Example 6

Form **6251**
(Rev. January 2006)
Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2006

Attachment
Sequence No. **32**

Name(s) shown on Form 1040

Your social security number

Gary

987 : 65 : 4321

Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)

1 If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 2), and go to line 2. Otherwise, enter the amount from Form 1040, line 38 (minus any amount on Form 8914, line 2), and go to line 7. (If less than zero, enter as a negative amount.)	1	310,000	
2 Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4, or 2½% of Form 1040, line 38	2		
3 Taxes from Schedule A (Form 1040), line 9	3		
4 Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions	4		
5 Miscellaneous deductions from Schedule A (Form 1040), line 26	5		
6 If Form 1040, line 38, is over \$150,500 (over \$75,250 if married filing separately), enter the amount from line 9 of the Itemized Deductions Worksheet on page A-9 of the Instructions for Schedules A & B (Form 1040)	6	()	
7 Tax refund from Form 1040, line 10 or line 21	7	()	
8 Investment interest expense (difference between regular tax and AMT)	8		
9 Depletion (difference between regular tax and AMT)	9		
10 Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10		
11 Interest from specified private activity bonds exempt from the regular tax	11		
12 Qualified small business stock (7% of gain excluded under section 1202)	12		
13 Exercise of incentive stock options (excess of AMT income over regular tax income)	13		
14 Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	14		
15 Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15		
16 Disposition of property (difference between AMT and regular tax gain or loss)	16		
17 Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	17		
18 Passive activities (difference between AMT and regular tax income or loss)	18		
19 Loss limitations (difference between AMT and regular tax income or loss)	19		
20 Circulation costs (difference between regular tax and AMT)	20		
21 Long-term contracts (difference between AMT and regular tax income)	21		
22 Mining costs (difference between regular tax and AMT)	22		
23 Research and experimental costs (difference between regular tax and AMT)	23		
24 Income from certain installment sales before January 1, 1987	24	()	
25 Intangible drilling costs preference	25		
26 Other adjustments, including income-based related adjustments	26		
27 Alternative tax net operating loss deduction	27	()	
28 Alternative minimum taxable income. Combine lines 1 through 27. (If married filing separately and line 28 is more than \$191,000, see page 7 of the instructions.)	28	310,000	

Part II Alternative Minimum Tax

29 Exemption. (If this form is for a child under age 14, see page 7 of the instructions.)																	
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">IF your filing status is . . .</td> <td style="width: 30%; text-align: center;">AND line 28 is not over . . .</td> <td style="width: 30%; text-align: center;">THEN enter on line 29 . . .</td> <td></td> </tr> <tr> <td>Single or head of household</td> <td style="text-align: right;">\$112,500</td> <td style="text-align: right;">\$42,500</td> <td rowspan="3" style="font-size: 3em; vertical-align: middle;">}</td> </tr> <tr> <td>Married filing jointly or qualifying widow(er)</td> <td style="text-align: right;">150,000</td> <td style="text-align: right;">62,550</td> </tr> <tr> <td>Married filing separately</td> <td style="text-align: right;">75,000</td> <td style="text-align: right;">31,275</td> </tr> </table>	IF your filing status is . . .	AND line 28 is not over . . .	THEN enter on line 29 . . .		Single or head of household	\$112,500	\$42,500	}	Married filing jointly or qualifying widow(er)	150,000	62,550	Married filing separately	75,000	31,275	29	0	
IF your filing status is . . .	AND line 28 is not over . . .	THEN enter on line 29 . . .															
Single or head of household	\$112,500	\$42,500	}														
Married filing jointly or qualifying widow(er)	150,000	62,550															
Married filing separately	75,000	31,275															
If line 28 is over the amount shown above for your filing status, see page 7 of the instructions.																	
30 Subtract line 29 from line 28. If zero or less, enter -0- here and on lines 33 and 35 and stop here	30	310,000															
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;">31 • If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), <u>complete Part III on the back and enter the amount from line 55 here.</u></td> <td style="width: 30%;"></td> <td style="width: 30%;"></td> <td rowspan="2" style="font-size: 3em; vertical-align: middle;">}</td> </tr> <tr> <td>• All others: If line 30 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result.</td> <td></td> <td></td> </tr> </table>	31 • If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), <u>complete Part III on the back and enter the amount from line 55 here.</u>			}	• All others: If line 30 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result.			31	58,600								
31 • If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), <u>complete Part III on the back and enter the amount from line 55 here.</u>			}														
• All others: If line 30 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result.																	
32 Alternative minimum tax foreign tax credit (see page 7 of the instructions)	32	0															
33 Tentative minimum tax. Subtract line 32 from line 31	33	58,600															
34 Tax from Form 1040, line 44 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 47). If you used Schedule J to figure your tax, the amount for line 44 of Form 1040 must be refigured without using Schedule J (see page 9 of the instructions)	34	53,382															
35 Alternative minimum tax. Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35	5,218															

For Paperwork Reduction Act Notice, see page 9 of the instructions.

Cat. No. 13600G

Form **6251** (2006) (Rev. 1-2006)

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For Example 6

Part III Tax Computation Using Maximum Capital Gains Rates

36 Enter the amount from Form 6251, line 30				36	310,000
37 Enter the amount from line 6 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44, or the amount from line 13 of the Schedule D Tax Worksheet on page D-9 of the instructions for Schedule D (Form 1040), whichever applies (as figured for the AMT, if necessary) (see page 9 of the instructions)	37	200,000			
38 Enter the amount from Schedule D (Form 1040), line 19 (as figured for the AMT, if necessary) (see page 9 of the instructions)	38	0			
39 If you did not complete a Schedule D Tax Worksheet for the regular tax or the AMT, enter the amount from line 37. Otherwise, add lines 37 and 38, and enter the smaller of that result or the amount from line 10 of the Schedule D Tax Worksheet (as figured for the AMT, if necessary)	39	200,000			
40 Enter the smaller of line 36 or line 39				40	200,000
41 Subtract line 40 from line 36				41	110,000
42 If line 41 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 41 by 26% (.26). Otherwise, multiply line 41 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result				42	28,600
43 Enter: <ul style="list-style-type: none"> • \$61,300 if married filing jointly or qualifying widow(er), • \$30,650 if single or married filing separately, or • \$41,050 if head of household. 	43	30,650			
44 Enter the amount from line 7 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44, or the amount from line 14 of the Schedule D Tax Worksheet on page D-9 of the instructions for Schedule D (Form 1040), whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter -0-	44	103,750			
45 Subtract line 44 from line 43. If zero or less, enter -0-	45	0			
46 Enter the smaller of line 36 or line 37	46	200,000			
47 Enter the smaller of line 45 or line 46	47	0			
48 Multiply line 47 by 5% (.05)				48	0
49 Subtract line 47 from line 46	49	200,000			
50 Multiply line 49 by 15% (.15)				50	30,000
If line 38 is zero or blank, skip lines 51 and 52 and go to line 53. Otherwise, go to line 51.					
51 Subtract line 46 from line 40	51				
52 Multiply line 51 by 25% (.25)				52	
53 Add lines 42, 48, 50, and 52				53	58,600
54 If line 36 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 36 by 26% (.26). Otherwise, multiply line 36 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result	54				83,300
55 Enter the smaller of line 53 or line 54 here and on line 31				55	58,600

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Observations for Example 6

- The 15% tax rate that applies to Gary's regular tax computation on the \$200,000 long-term capital gain also applies for AMT purposes. This is accomplished in Part III on page 2 of Form 6251. **Gary's tax on the capital gain is \$30,000 ($\$200,000 \times 15\%$) for both regular and AMT purposes.**
- **Gary loses his \$42,500 AMT exemption** due to the \$200,000 long-term capital gain on the sale of the land. With the additional \$200,000, his 2006 AMTI of \$310,000 exceeds the 2006 AMT exemption phase-out ceiling amount of \$282,500 for single taxpayers.
- If Gary had been allowed to claim his \$42,500 AMT exemption, he would have no AMT liability for 2006.
- Because Gary reported net capital gain income, Part III of Form 6251 must be completed in order to arrive at the \$58,600 figure shown on line 31, Part II.

Planning Suggestion. Gary should have considered an installment sale when he sold the land in December 2006. If he received only half of the \$500,000 sales price in 2006 instead of all of it, he would have owed only \$827 of AMT on his 2006 return. If Congress addresses the AMT problem for 2007, as it did for 2006, then his total AMT taxes could be less by realizing the gain over two years, 2006 and 2007. However, if Congress does not fix AMT for 2007, he may pay more AMT taxes under the installment-sale method.

See pages 28 and 553 in the *2003 University of Illinois Federal Tax Workbook* and pages 250–252 in the *2004 University of Illinois Federal Tax Workbook* for more details.

Home Mortgage Interest. For AMT computation purposes, only **qualified housing interest** is allowed as a deduction.⁴ Qualified housing interest is defined as interest incurred on debt used to **acquire, construct, or substantially improve** a taxpayer's principal residence and one other residence.⁵ For AMT purposes, the **other residence** may be a house, condominium, apartment, or mobile home. However, debt incurred on a boat or a motor home does not qualify.⁶

The most common types of home mortgage loans in which the related interest is **not deductible** for AMT purposes are:

- A **home equity loan** when the loan proceeds are **not** used to buy, build, or improve a principal residence or a second home. Examples include home equity loan proceeds used to pay for college expenses, weddings, vacations and federal and state income taxes.
- A refinanced home mortgage when the amount of the refinanced loan **exceeds** the outstanding principal balance immediately before the refinancing.

Example 7. Shep and Marge owed \$150,000 on their home mortgage. They refinanced the mortgage at a lower rate of interest in 2006 and borrowed a total of \$175,000. The interest they pay on the excess \$25,000 of refinanced loan proceeds is not deductible for AMT purposes.

This AMT adjustment, which can be substantial, is reported on line 4, Form 6251. It is not automatically computed by tax software programs. It may be necessary for the practitioner to question the client about how the proceeds of mortgages and home equity loans were used.

⁴ IRC §56(b)(1)(C)(i)

⁵ IRC §56(e)(1)

⁶ IRC §56(e)(2)

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Example 8. George and Hillary paid the following mortgage interest in 2006:

- \$5,000 on a mortgage used to buy their personal residence.
- \$4,000 on a refinancing loan they took out in June 2006. The amount of the refinanced loan equaled the outstanding principal owed on their original mortgage.
- \$2,000 of interest paid on a home equity loan they obtained in July. The loan proceeds were used to buy an SUV.

Question 8A. How much of the total \$11,000 of mortgage interest paid in 2006 is deductible for AMT purposes?

Answer 8A. \$9,000. The \$2,000 interest paid on the home equity loan should be shown an adjustment on line 4 on the 2006 Form 6251. See the completed worksheet from the Form 6251 Instructions for George and Hillary.

Home Mortgage Interest Adjustment Worksheet—Line 4	
(Keep for Your Records)	
1. Enter the total of the home mortgage interest you deducted on lines 10 through 12 of Schedule A (Form 1040)	1. <u>11,000</u>
2. Enter the part, if any, of the interest included on line 1 above that was paid on an eligible mortgage (defined on this page)	2. <u>5,000</u>
3. Enter the part, if any, of the interest included on line 1 above that was paid on a mortgage whose proceeds were used in a refinancing (including a second or later refinancing) of an eligible mortgage. Do not include any interest paid on the part of the balance of the new mortgage that exceeded the balance of the original eligible mortgage immediately before it was refinanced (or, if smaller, the balance of any prior refinanced mortgage immediately before that mortgage was refinanced)	3. <u>4,000</u>
4. Enter the part, if any, of the interest included on line 1 above that was paid on a mortgage: • Taken out before July 1, 1982, and • Secured, at the time the mortgage was taken out, by your main home or a qualified dwelling used by you or your family (see definitions on this page). Do not include any amount entered on line 2 or line 3 above	4. <u>0</u>
5. Add lines 2 through 4	5. <u>9,000</u>
6. Subtract line 5 from line 1 and enter the result on Form 6251, line 4	6. <u>2,000</u>

Personal Exemptions. Personal exemptions are allowed for regular tax purposes, but not for AMT purposes. Taxpayers with several children and a small regular taxable income may be liable for AMT although they have no AMT adjustment or preference items. There have been several court cases dealing with this AMT adjustment, including the *Klaassen Appeals Court case*.⁷

⁷ *David R. and Margaret J. Klassen v. Commr.*, 10th Cir. Ct. of Appeals (1999), 99-1 USTC ¶50,418, April 7, 1999

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Incentive Stock Options (ISOs). For regular tax purposes, this form of additional compensation is given favorable (deferred) tax treatment until the stock acquired by the exercise of the ISO is sold. However, under AMT rules, the difference between the market price of the stock and the amount that is actually paid for the stock must be recognized in computing AMTI.

This AMT adjustment is reported on line 13, Form 6251. It can have devastating tax results for taxpayers who exercise an ISO and fail to sell the acquired stock in the year the ISO is exercised. This situation materializes when the value of the ISO-acquired stock plummets in a later year. In many instances, taxpayers caught in this tax trap report huge AMT liabilities in the year the ISO is exercised due to the required AMT adjustment. In reality, many of these taxpayers actually have practically worthless stock in later years but are still forced to pay the AMT liability incurred when the ISO was exercised.

Note. See page 469 in the *2005 University of Illinois Federal Tax Workbook* for more details on this type of situation.

Example 9. Jane exercised an ISO granted to her by her employer in March 2006. **This was not a cashless exercise.** Jane used her own funds for the \$30,000 grant price she paid for the stock. **She did not sell the stock acquired by the exercise of the ISO in 2006 since she expects the stock to appreciate.** Following are the details relating to her exercise of the ISO in 2006:

Number of shares	1,000
Exercise grant price per share	30
Market value price per share at the time of exercise	100
Untaxed (for regular tax) "spread" amount per share	70
Untaxed (for regular tax) total amount of the "spread" gain (1,000 shares × \$70)	70,000

Tax Solution for Example 9. Jane must report \$70,000 as an AMT adjustment on line 13 on her 2006 Form 6251. This likely causes Jane to owe AMT in 2006. This \$70,000 phantom AMT gain may evaporate and result in an actual realized loss for regular tax purposes if the price of the stock declines to under \$30 per share when Jane sells the 1,000 shares.

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For Example 9

Form 6251		Alternative Minimum Tax—Individuals		OMB No. 1545-0074
Department of the Treasury Internal Revenue Service (99)		▶ See separate instructions.		2006 Attachment Sequence No. 32
Name(s) shown on Form 1040		▶ Attach to Form 1040 or Form 1040NR.		Your social security number
Jane				111 : 11 : 1111
Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)				
1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 6), and go to line 2. Otherwise, enter the amount from Form 1040, line 38 (minus any amount on Form 8914, line 6), and go to line 7. (If less than zero, enter as a negative amount.)	1		
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4, or 2½% of Form 1040, line 38	2		
3	Taxes from Schedule A (Form 1040), line 9	3		
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions	4		
5	Miscellaneous deductions from Schedule A (Form 1040), line 26	5		
6	If Form 1040, line 38, is over \$150,500 (over \$75,250 if married filing separately), enter the amount from line 11 of the Itemized Deductions Worksheet on page A-6 of the Instructions for Schedule A (Form 1040)	6	()
7	Tax refund from Form 1040, line 10 or line 21	7	()
8	Investment interest expense (difference between regular tax and AMT)	8		
9	Depletion (difference between regular tax and AMT)	9		
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10		
11	Interest from specified private activity bonds exempt from the regular tax	11		
12	Qualified small business stock (7% of gain excluded under section 1202)	12		
13	Exercise of incentive stock options (excess of AMT income over regular tax income)	13		70,000
14	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	14		
15	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15		
	Disposition of property (difference between AMT and regular tax gain or loss)			

Observations for Example 9

- In computing the gain or loss for **regular tax purposes** on the eventual sale of the 1,000 shares, Jane's basis is the **\$30,000** she actually paid for the stock.
- In computing the **AMT** gain or loss on the sale of the 1,000 shares, Jane's basis is **\$100,000** (\$30,000 basis for regular tax + the 2006 \$70,000 AMT adjustment).

Assume Jane sells the 1,000 shares in 2010 for \$130 per share. The 1,000 shares did not split and in 2010 current tax laws concerning AMT apply. **The tax consequences on her 2010 tax return are:**

- A long-term capital gain of \$100,000 on her 2010 Schedule D (\$130,000 sales price less regular tax basis of \$30,000)
- An AMT gain of \$30,000 (\$130,000 sales price less AMT basis of \$100,000)
- A **negative entry** of \$70,000 on line 16 on her 2010 Form 6251. Line 16 on Form 6251 is "Disposition of property (difference between AMT and regular tax gain or loss)."
- The \$70,000 AMT adjustment is a **deferral adjustment** as opposed to an exclusion adjustment. **If Jane does owe AMT for 2006, she may be entitled to a minimum tax credit on her 2007 or subsequent tax returns.** Jane's tax practitioner must prepare a 2007 Form 8801, *Credit for Prior Year Minimum Tax*, in order to claim this potential credit.
- One way to guarantee that an exercise of an ISO will never result in a phantom AMT gain is to sell the ISO-acquired stock in the **same year** the ISO is exercised. This is normally done by employees who use a **cashless transaction** in exercising the ISO to acquire the stock followed by an immediate sale of the stock. In this type of ISO exercise, the employee is not required to use any personal funds to pay for the stock.

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Note. See page 256 in the *2004 University of Illinois Federal Tax Workbook* for a thorough explanation and example of using a **cashless transaction** to acquire stock via exercising an ISO.

Planning Suggestion. Assume that Jane's ISO exercise period did not terminate in 2006. If so, she could have made a partial ISO exercise of 500 shares in 2006 and then she could have completed the exercise of the remaining 500 shares in 2007. If that was done, assuming the market value remained at \$100 per share in 2007, her 2006 and 2007 AMT adjustments on line 13, Form 6251 would each only be \$35,000, or half of the \$70,000 AMT adjustment in **Example 9**. This strategy is less likely to result in an AMT liability for 2006 and/or 2007.

Investment Interest. If a taxpayer completes Form 4952, *Investment Interest Expense Deduction*, for regular tax purposes, a second Form 4952 must be prepared for AMT purposes. **This AMT adjustment, which may be positive or negative, is reported on line 8, Form 6251.** Similar to the AMT adjustment for home mortgage interest, it is not automatically computed accurately by computer software programs.

Form	4952	Investment Interest Expense Deduction	OMB No. 1545-0191
Department of the Treasury Internal Revenue Service (99)		▶ Attach to your tax return.	2006
Name(s) shown on return			Attachment Sequence No. 51
			Identifying number
Part I Total Investment Interest Expense			
1	Investment interest expense paid or accrued in 2006 (see instructions)	1	
2	Disallowed investment interest expense from 2005 Form 4952, line 7	2	
3	Total investment interest expense. Add lines 1 and 2	3	
Part II Net Investment Income			
4a	Gross income from property held for investment (excluding any net gain from the disposition of property held for investment)	4a	
4b	Qualified dividends included on line 4a	4b	
4c	Subtract line 4b from line 4a	4c	
4d	Net gain from the disposition of property held for investment	4d	
4e	Enter the smaller of line 4d or your net capital gain from the disposition of property held for investment (see instructions)	4e	
4f	Subtract line 4e from line 4d	4f	
4g	Enter the amount from lines 4b and 4e that you elect to include in investment income (see instructions)	4g	
4h	Investment income. Add lines 4c, 4f, and 4g	4h	
5	Investment expenses (see instructions)	5	
6	Net investment income. Subtract line 5 from line 4h. If zero or less, enter -0-	6	
Part III Investment Interest Expense Deduction			
7	Disallowed investment interest expense to be carried forward to 2007. Subtract line 6 from line 3. If zero or less, enter -0-	7	
8	Investment interest expense deduction. Enter the smaller of line 3 or 6. See instructions.	8	

Investment interest expense is deductible for both regular tax and AMT to the extent of net investment income. However, the amount of **investment interest expense** (line 1, Form 4952) and **net investment income** (line 6, Form 4952) can differ.

Line 1 of the AMT Form 4952, *Investment Interest Expense Deduction*, must include any interest expense:

- On a home equity loan whose proceeds were used to buy investment property such as stocks or bonds, and
- Related to the purchase of private activity bonds issued after August 7, 1986.

When **Part II** of the AMT Form 4952 is prepared, **net investment income** includes interest earned on private activity bonds issued after August 7, 1986, less any related investment expenses.

Contingent Attorney Fees. The payment of contingent attorney fees by successful litigants may create an AMT liability in the year the fees are paid. The general rule is that the contingent fee must first be included in gross income of the taxpayer and then deducted as a miscellaneous itemized deduction on Schedule A.

Note. See the “Contingent Attorney Fees” section of “Problem 4, Legal Fees,” later in this chapter for more information.

AMT CREDIT (FORM 8801)

Form 8801, *Credit for Prior Year Minimum Tax - Individuals, Estates and Trusts*, is used to obtain the AMT credit. AMT liability is created by two types of AMT adjustments or preference items: deferral items and exclusion items.

Deferral Items. The following are examples with Form 6251 line numbers (not all inclusive):

1. Exercise of incentive stock options (excess of AMT income over regular tax income) (line 13)
2. Disposition of property (difference between AMT and regular tax gain or loss) (line 16)
3. Depreciation on assets placed in service after 1986 (difference between regular tax and AMT) (line 17)

Exclusion Items. The following are examples with Form 6251 line numbers (all inclusive):

1. Medical and dental (line 2)
2. Taxes from line 9 of Schedule A (line 3)
3. Home mortgage interest adjustment (line 4)
4. Miscellaneous itemized deductions (line 5)
5. Amount of itemized deductions disallowed because of AGI limitations (line 6 – entered as a negative amount)
6. State tax refunds (line 7, entered as a negative amount)
7. Investment interest expense (difference between regular tax and AMT) (line 8)
8. Depletion (difference between regular tax and AMT) (line 9)
9. Net operating loss deduction from line 21 of Form 1040 (line 10, entered as a positive amount)
10. Interest from private activity bonds exempt from regular tax issued after August 7, 1986 (line 11)
11. Qualified small business stock (7% of gain excluded under §1202) (line 12)
12. Standard deduction (no specific line — factored into line 1)
13. Personal exemptions (no specific line — factored into line 1)

Exclusion items reported on prior Form(s) 6251 can never create a current year minimum tax credit on Form 8801. Exclusion items that produced prior year AMT liability result in a permanent increase in total tax.

The minimum tax credit is the amount of prior AMT liability caused by the deferral items.

2006 Workbook

Example 10. Ryan, who is single, exercised an incentive stock option in 2005 and still owns the ISO-acquired stock. His 2005 AMT adjustment on the exercise for the untaxed (for regular tax) “spread” amount was \$90,000. This \$90,000 was reported on line 13 on Ryan’s 2005 Form 6251.

Wages			\$80,000
Schedule F loss			(28,000)
State income tax refund (line 7, Form 6251)*			<u>500</u>
Ryan’s 2005 AGI			\$52,500
Less: itemized deductions			
State income tax*	\$3,000		
Real estate tax on home*	<u>6,000</u>		
Subtotal (line 3, Form 6251)*	\$9,000	\$ 9,000	
Home mortgage interest		11,000	
Contributions		<u>4,500</u>	
		\$24,500	(24,500)
Line 41, Form 1040 (line 1, Form 6251)*			<u>\$28,000</u>

*Form 6251 item

Ryan’s 2005 regular taxable income was \$24,800 (\$28,000 less the personal exemption of \$3,200). His regular tax from the tax tables was \$3,359.

Note. Ryan’s only depreciation deduction on his 2005 Schedule F was a \$179 deduction. Therefore, no entry is required on line 17, Form 6251. In addition, all of the home mortgage interest is related to funds he used to buy his home.

Ryan’s completed 2005 Form 6251 and his 2006 Form 8801 are found on the next two pages. He is entitled to a 2006 minimum tax credit of \$4,500, as shown on his 2006 Form 8801.

2006 Workbook

For Example 10

Form **6251**
(Rev. January 2006)
Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074
2005
Attachment
Sequence No. **32**

2

Name(s) shown on Form 1040

Your social security number
147 : 25 : 8369

Ryan

Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 2), and go to line 2. Otherwise, enter the amount from Form 1040, line 38 (minus any amount on Form 8914, line 2), and go to line 7. (If less than zero, enter as a negative amount.)	1	28,000
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4, or 2½% of Form 1040, line 38	2	
3	Taxes from Schedule A (Form 1040), line 9	3	9,000
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions	4	
5	Miscellaneous deductions from Schedule A (Form 1040), line 26	5	
6	If Form 1040, line 38, is over \$145,950 (over \$72,975 if married filing separately), enter the amount from line 9 of the Itemized Deductions Worksheet on page A-9 of the Instructions for Schedules A & B (Form 1040)	6	()
7	Tax refund from Form 1040, line 10 or line 21	7	(500)
8	Investment interest expense (difference between regular tax and AMT)	8	
9	Depletion (difference between regular tax and AMT)	9	
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10	
11	Interest from specified private activity bonds exempt from the regular tax	11	
12	Qualified small business stock (7% of gain excluded under section 1202)	12	
13	Exercise of incentive stock options (excess of AMT income over regular tax income)	13	90,000
14	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	14	
15	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	15	
16	Disposition of property (difference between AMT and regular tax gain or loss)	16	
17	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	17	
18	Passive activities (difference between AMT and regular tax income or loss)	18	
19	Loss limitations (difference between AMT and regular tax income or loss)	19	
20	Circulation costs (difference between regular tax and AMT)	20	
21	Long-term contracts (difference between AMT and regular tax income)	21	
22	Mining costs (difference between regular tax and AMT)	22	
23	Research and experimental costs (difference between regular tax and AMT)	23	
24	Income from certain installment sales before January 1, 1987	24	()
25	Intangible drilling costs preference	25	
26	Other adjustments, including income-based related adjustments	26	
27	Alternative tax net operating loss deduction	27	()
28	Alternative minimum taxable income. Combine lines 1 through 27. (If married filing separately and line 28 is more than \$191,000, see page 7 of the instructions.)	28	126,500

Part II Alternative Minimum Tax

29	Exemption. (If this form is for a child under age 14, see page 7 of the instructions.)		
	AND line 28 is not over . . .	THEN enter on line 29 . . .	
	Single or head of household \$112,500	\$40,250	} 29
	Married filing jointly or qualifying widow(er) 150,000	58,000	
	Married filing separately 75,000	29,000	
	If line 28 is over the amount shown above for your filing status, see page 7 of the instructions.		
30	Subtract line 29 from line 28. If zero or less, enter -0- here and on lines 33 and 35 and stop here	30	89,750
31	<ul style="list-style-type: none"> • If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 55 here. • All others: If line 30 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result. 	31	23,335
32	Alternative minimum tax foreign tax credit (see page 7 of the instructions)	32	0
33	Tentative minimum tax. Subtract line 32 from line 31	33	23,335
34	Tax from Form 1040, line 44 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 47). If you used Schedule J to figure your tax, the amount for line 44 of Form 1040 must be refigured without using Schedule J (see page 9 of the instructions)	34	3,359
35	Alternative minimum tax. Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35	19,976

For Paperwork Reduction Act Notice, see page 9 of the instructions.

Cat. No. 13600G

Form **6251** (2005) (Rev. 1-2006)

2006 Workbook

For Example 10

Form **8801**
 Department of the Treasury
 Internal Revenue Service (99)

Credit for Prior Year Minimum Tax— Individuals, Estates, and Trusts

▶ See separate instructions.
 ▶ Attach to Form 1040, 1040NR, or 1041.

OMB No. 1545-1073
2006
 Attachment
 Sequence No. 74

Name(s) shown on return
Ryan

Identifying number
147-258-369

Part I Net Minimum Tax on Exclusion Items

1 Combine lines 1, 6, and 10 of your 2005 Form 6251. Estates and trusts, see instructions	1	28,000	
2 Enter adjustments and preferences treated as exclusion items (see instructions) 9,000 - 500	2	8,500	
3 Minimum tax credit net operating loss deduction (see instructions)	3	()	
4 Combine lines 1, 2, and 3. If zero or less, enter -0- here and on line 15 and go to Part II. If more than \$191,000 and you were married filing separately for 2005, see instructions	4	36,500	
5 Enter: \$58,000 if married filing jointly or qualifying widow(er) for 2005; \$40,250 if single or head of household for 2005; or \$29,000 if married filing separately for 2005. Estates and trusts, enter \$22,500	5	40,250	
6 Enter: \$150,000 if married filing jointly or qualifying widow(er) for 2005; \$112,500 if single or head of household for 2005; or \$75,000 if married filing separately for 2005. Estates and trusts, enter \$75,000	6	112,500	
7 Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	0	
8 Multiply line 7 by 25% (.25)	8		
9 Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 14, see instructions	9	40,250	
10 Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15 and go to Part II. Form 1040NR filers, see instructions	10	0	
11 • If for 2005 you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b (Form 1041, line 2b(2)); or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (lines 14a and 15, column (2), of Schedule D (Form 1041)), complete Part III of Form 8801 and enter the amount from line 46 here. • All others: If line 10 is \$175,000 or less (\$87,500 or less if married filing separately for 2005), multiply line 10 by 26% (.26). Otherwise, multiply line 10 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately for 2005) from the result.	11		
12 Minimum tax foreign tax credit on exclusion items (see instructions)	12		
13 Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13		
14 Enter the amount from your 2005 Form 6251, line 34, or 2005 Form 1041, Schedule I, line 55	14		
15 Net minimum tax on exclusion items. Subtract line 14 from line 13. If zero or less, enter -0-	15	0	

Part II Minimum Tax Credit and Carryforward to 2007

16 Enter the amount from your 2005 Form 6251, line 35, or 2005 Form 1041, Schedule I, line 56	16	19,976	
17 Enter the amount from line 15 above	17	0	
18 Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	19,976	
19 2005 minimum tax credit carryforward. Enter the amount from your 2005 Form 8801, line 26	19	0	
20 Enter the total of your 2005 unallowed nonconventional source fuel credit and 2005 unallowed qualified electric vehicle credit (see instructions)	20	0	
21 Combine lines 18, 19, and 20. If zero or less, stop here and see instructions	21	19,976	
22 Enter your 2006 regular income tax liability minus allowable credits (see instructions)	22	4,500	
23 Enter the amount from your 2006 Form 6251, line 33, or 2006 Form 1041, Schedule I, line 54	23	0	
24 Subtract line 23 from line 22. If zero or less, enter -0-	24	4,500	
25 Minimum tax credit. Enter the smaller of line 21 or line 24. Also enter this amount on your 2006 Form 1040, line 55; Form 1040NR, line 50; or Form 1041, Schedule G, line 2d	25	4,500	
26 Minimum tax credit carryforward to 2007. Subtract line 25 from line 21. Keep a record of this amount because you may use it in future years	26	15,476	

For Paperwork Reduction Act Notice, see page 4 of the instructions.

Cat. No. 10002S

Form **8801** (2006)

Observations Regarding Ryan's 2006 Form 8801

1. Ryan's 2006 regular tax of \$4,500 is higher than his 2005 regular tax of \$3,359. The main reason for this is that his 2006 Schedule F reported a smaller net loss than reported on his 2005 Schedule F.
2. Ryan has no tentative minimum tax for 2006 (line 33 of his 2006 Form 6251, not shown). Therefore, his 2006 minimum tax credit of \$4,500 is not limited. If Ryan did have 2006 tentative minimum tax, his \$4,500 credit would be reduced by the amount of his 2006 tentative minimum tax.
3. After applying the \$4,500 minimum tax credit, Ryan's net 2006 regular tax liability is zero.
4. Ryan is entitled to a \$15,476 minimum tax carryforward to his 2007 tax return. The \$15,476 will be reported on line 19 on his 2007 Form 8801 as "2006 minimum tax credit carryforward."
5. Ryan may be entitled to a minimum tax credit on his 2007 and subsequent year returns. His \$15,476 unused credit from 2006 may be carried forward indefinitely.

AMT NET OPERATING LOSS (AMT NOL)

Any NOL reported for regular tax purposes must be recomputed for AMT purposes (AMT NOL). The regular tax NOL must be modified by any AMT adjustment and preference items to the extent they were considered in calculating the regular tax NOL.

In less complicated situations, the AMT NOL is the same as the regular tax NOL except that the computation of the nonbusiness deduction adjustment includes only itemized deductions allowable for AMT purposes.⁸

Example 11. Jesse operates a garbage disposal business. His 2006 Schedule C reports a net loss of \$80,000. The regular tax depreciation exceeds AMT depreciation by \$20,000. If there are no other AMT adjustment or preference items, Jesse's 2006 NOLs are:

- \$80,000 regular tax NOL
- \$60,000 AMT NOL (\$80,000 – 20,000)

Other AMT NOL Rules

1. The AMT NOL is carried to the same tax years as the regular tax NOL. However, unlike the rules for regular tax, the AMT NOL is only allowed to reduce or eliminate 90%⁹ of alternative minimum taxable income (AMTI). Any AMT NOL not used up due to this limitation may be carried to future tax years.
2. The AMT NOL must be used to reduce or eliminate AMTI in the carryback or carryover year regardless of whether AMT is due for those years.
3. If the taxpayer elects to forgo the carryback period for the regular tax NOL, the election also applies to the AMT NOL.

⁸ J.K. Lasser, *Your Income Tax 2006*

⁹ There are exceptions to this rule for AMT NOLs attributed to Gulf Opportunity Zone losses. See instructions for Form 6251.

PROBLEM 3: NONBUSINESS CASUALTIES

BACKGROUND INFORMATION

The rules for casualty and theft losses/gains for personal use property are governed by IRC §165(c)(3) and applicable Treasury regulations. IRC §165 is entitled “Losses.”

Real and alleged casualty and theft losses for such properties historically resulted in numerous court cases. From an analysis of the court case decisions, it is apparent that many taxpayers who reported casualty and theft losses on their tax returns have been disappointed in the final resolution of their disputes with the IRS.

The main reasons for the significant number of court cases on the issue appear to be:

- Proving to the satisfaction of the IRS and the courts that a casualty actually occurred
- Disagreements on the value of the damaged or stolen property immediately before and immediately after the casualty or theft
- Disagreements on the cost of the damaged or stolen property

As a result of the volume of tax disputes on this issue, Congress, with the encouragement of the IRS, passed a provision in 1982. It limited all personal use casualty and thefts losses incurred in tax years after 1982 to the amount in excess of 10% of AGI. That provision and the massive Tax Reform Act of 1986 which severely limited itemized deductions have resulted in far fewer casualty loss deductions on individual tax returns.

DEFINITION OF A NONBUSINESS CASUALTY

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A sudden event is one that is swift, not gradual or progressive.
- An unexpected event is one that is ordinarily unanticipated and unintended.
- An unusual event is one that is not a day-to-day occurrence and that is not typically of the activity in which the taxpayer is engaged.¹⁰

As defined by IRC 165(c)(3), a casualty to nonbusiness property is a loss that arises from “**fire, storm, shipwreck, or other casualty, or from theft.**”

Note. Many tax disputes have centered on trying to ascertain what the term “other casualty” means. Naturally, the IRS interpretation has generally been limited while taxpayers have taken a more expansive position.

The following represents a sampling of various court case decisions and IRS rulings dealing with casualty and theft losses for personal use property and whether the loss was determined to be deductible under IRC §165.

1. Damage to house caused by jet plane “sonic boom” — Yes¹¹
2. Damage to fur coat by moths — No¹²
3. Routine breakage of china — No¹³

¹⁰ IRS Pub. 547, *Casualties, Disasters, and Thefts*

¹¹ Rev. Rul. 60-329

¹² Rev. Rul. 55-327

¹³ *Diggs v. Commr.*, TC Memo 1959-99, May 19, 1959

4. Antique vase broken by a cat having a fit — No¹⁴
5. Damage to trees in residential yard caused by ice storm — Yes¹⁵
6. Son's college room and board expenses paid for a semester he could not complete due to his being drafted by the military — No¹⁶
7. Fire in engine of an old car — No¹⁷
8. Loss of unused sick leave caused by job dismissal — No¹⁸
9. Damage to residence caused by rats — No¹⁹
10. Loss of a ring placed in a glass of ammonia by wife for cleaning and thrown in garbage disposal by husband — Yes²⁰
11. Losses caused by electrical blackouts — Yes²¹
12. Decrease in value of residence caused by noise pollution — No²²
13. Damage from a leaky ceiling caused by squirrels eating holes in roof — No²³
14. Fire loss to residence caused when owner deliberately started the fire — No²⁴

FORM 4684, CASUALTIES AND THEFTS

All losses or gains from casualties or thefts for personal use property are initially reported on Form 4684, Section A, page 1. Any gain is carried to Schedule D as either a short-term or long-term capital gain. Any allowable loss on line 21 of Form 4684 is carried to line 19, Schedule A, *Casualty and Theft Losses*.

Note. Insured casualties sometimes result in gains. This can occur when insurance proceeds exceed the adjusted basis of the damaged or stolen personal use property at the time of the casualty. The gain is taxable as a capital gain unless it is deferred by buying replacement property during the normal 2-year replacement period. The replacement period ends two years after the end of the first tax year in which any part of the gain is realized.

¹⁴ *Dyer v. Commr.*, TC Memo 1961-141, May 18, 1961

¹⁵ *Hollington v. Commr.*, TC Memo 1956-132, May 31, 1956

¹⁶ *Dubin v. Commr.*, TC Memo 1976-256, August 17, 1976

¹⁷ *Pugh v. Commr.*, TC Memo 1985-67, February 13, 1985

¹⁸ *Marks v. Commr.*, TC Memo 1963-224, August 21, 1963

¹⁹ *Edward Banigan*, 10 TCM 561, June 14, 1951

²⁰ *Carpenter v. Commr.*, TC Memo 1966-228, October 18, 1966

²¹ IRS News Release, November 12, 1965

²² *Adams v. Commr.*, TC Memo 1977-308, September 13, 1977

²³ Ltr. Rul. 8133097, May 22, 1981

²⁴ *Blackman v. Commr.*, 88 TC 677, March 24, 1987

2006 Workbook

EXAMPLES OF NONBUSINESS CASUALTIES

Two examples are shown next that illustrate how to apply the tax rules and complete the required forms and schedules for nonbusiness casualties. **Example 12 results in an allowable loss while Example 13 results in a taxable gain.** The facts in each example are similar except for the amount of insurance proceeds for the vacation home.

Example 12. Rich and Judy bought a vacation home located in California in 1995. It was damaged by fire in January 2006. The chart below show their cost basis and the fair market values of the house and furnishings immediately before and immediately after the fire and the amount of insurance proceeds received for each. The insurance proceeds were received in March 2006.

Property	Cost	FMV before Casualty	FMV after Casualty	Insurance Proceeds
Residence	\$135,000	\$360,000	\$70,000	\$100,000
Furnishings	20,000	5,000	2,000	2,000

Rich and Judy hired a competent appraiser familiar with local real estate values to obtain the fair market value figures shown in the chart. They paid the following casualty-related expenses in 2006:

- \$1,000 for the appraisal fee
- \$8,000 in cleanup expenses
- \$200 for photographs taken after the fire as evidence of their casualty loss

This was their only casualty during 2006. Their 2006 AGI is \$140,000.

Note. Getting an appraisal of the property is the best way to measure and document the loss. However, the cost of repairs can be used to estimate the decrease in FMV²⁵ if all of the following conditions are met:

1. The repairs are actually made.
2. The repairs are necessary to bring the property back to its condition before the casualty.
3. The amount spent for the repairs is not excessive.
4. The repairs pertain only to the damage caused by the casualty.
5. The value of the property after the repairs is not more than the value of the property before the casualty.

²⁵ Treas. Reg. §1.165-7(a)(2)(ii)

2006 Workbook

For Example 12

Form **4684**

Casualties and Thefts

OMB No. 1545-0177

2006

Attachment Sequence No. **26**

Department of the Treasury
Internal Revenue Service

▶ See separate instructions.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

Name(s) shown on tax return

Identifying number

Rich and Judy

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property A **Vacation home located in Carmel, CA (acquired 7/10/1995)**

Property B **Furniture (acquired various dates)**

Property C

Property D

	Properties			
	A	B	C	D
2 Cost or other basis of each property	2 135,000	20,000		
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	3 100,000	2,000		
Note: If line 2 is more than line 3, skip line 4.				
4 Gain from casualty or theft. If line 3 is more than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.	4			
5 Fair market value before casualty or theft	5 360,000	5,000		
6 Fair market value after casualty or theft	6 70,000	2,000		
7 Subtract line 6 from line 5	7 290,000	3,000		
8 Enter the smaller of line 2 or line 7	8 135,000	3,000		
9 Subtract line 3 from line 8. If zero or less, enter -0-	9 35,000	1,000		
10 Casualty or theft loss. Add the amounts on line 9 in columns A through D	10 36,000			
11 Enter the smaller of line 10 or \$100. But if the loss arose in the Hurricane Katrina disaster area after August 24, 2005; Hurricane Rita disaster area after September 22, 2005; or Hurricane Wilma disaster area after October 22, 2005, and was caused by that particular hurricane, enter -0-	11 100			
12 Subtract line 11 from line 10	12 35,900			
Caution: Use only one Form 4684 for lines 13 through 21.				
13 Add the amounts on line 12 of all Forms 4684	13 35,900			
14 Add the amounts on line 4 of all Forms 4684	14 0			
15 <ul style="list-style-type: none"> • If line 14 is more than line 13, enter the difference here and on Schedule D. Do not complete the rest of this section (see instructions). • If line 14 is less than line 13, enter -0- here and go to line 16. • If line 14 is equal to line 13, enter -0- here. Do not complete the rest of this section. 	15 0			
16 If line 14 is less than line 13, enter the difference	16 35,900			
17 Add the amounts on line 12 of all Forms 4684 on which you entered -0- on line 11.	17 0			
18 Is line 17 less than line 16? <input type="checkbox"/> No. Stop. Enter the amount from line 16 on Schedule A (Form 1040), line 19. Estates and trusts, enter the amount from line 16 on the "Other deductions" line of your tax return. <input type="checkbox"/> Yes. Subtract line 17 from line 16.	18 35,900			
19 Enter 10% of your adjusted gross income from Form 1040, line 38. Estates and trusts, see instructions	19 14,000			
20 Subtract line 19 from line 18. If zero or less, enter -0-	20 21,900			
21 Add lines 17 and 20. Also enter the result on Schedule A (Form 1040), line 19. Estates and trusts, enter the result on the "Other deductions" line of your tax return	21 21,900			

For Paperwork Reduction Act Notice, see page 4 of the instructions.

Cat. No. 129970

Form **4684** (2006)

2006 Workbook

Observations for Example 12

1. Rich and Judy's allowable casualty loss on line 21, Form 4684 is \$21,900. It will be entered on line 19 on their 2006 Schedule A (Casualty and Theft Losses).
2. The \$21,900 loss deducted on line 19, Schedule A is **not** subject to either:
 - The 2% of AGI limitation on itemized deductions (Schedule A, line 25)
 - The 3% of AGI reduction to itemized deductions (Schedule A, line 28)
3. The real property (vacation home) and the personal property (furniture) must be listed separately on line 1, Form 4684.
4. The \$1,000 appraisal fee, the \$8,000 cleanup expenses, and the \$200 cost of photographs are not considered in determining the \$290,000 decrease in fair market value. **However, the \$1,000 appraisal fee and the \$200 photograph expense were paid to determine their 2006 income tax liability. Therefore, both qualify as miscellaneous itemized deductions subject to the 2% limitation.**

Rich and Judy's adjusted basis in their vacation home property is now \$21,708 computed as follows:

Cost basis before fire	\$135,000
Less: insurance proceeds received	(100,000)
Less: deductible casualty loss (home only) [$\$35,000 \div \$36,000 \times \$21,900$]	(21,292)
Adjusted basis before repairs are made	\$ 13,708
Cleanup expenses	8,000
Adjusted basis after cleanup	<u>\$ 21,708</u>

Any repairs or improvements made to the home after the fire will increase their \$21,708 adjusted basis.

Example 13. The facts are identical to those shown for **Example 12** with two exceptions.

1. Instead of receiving \$100,000 insurance proceeds for the damage to the residence, Rich and Judy received \$300,000 in March 2006.
2. Rich and Judy spent \$200,000 of the \$300,000 insurance proceeds in 2006 to make repairs and improvements to the home after the fire. The \$200,000 of repairs and improvements is in addition to the \$8,000 of cleanup expenses they paid.

2006 Workbook

For Example 13

Form **4684**

Casualties and Thefts

OMB No. 1545-0177

2006

Attachment Sequence No. **26**

Department of the Treasury
Internal Revenue Service

▶ See separate instructions.
▶ Attach to your tax return.
▶ Use a separate Form 4684 for each casualty or theft.

Name(s) shown on tax return

Identifying number

Rich and Judy

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property A **Vacation home located in Carmel, CA (acquired 7/10/1995)**

Property B **Furniture (acquired various dates)**

Property C

Property D

		Properties			
		A	B	C	D
2	Cost or other basis of each property	135,000	20,000		
3	Insurance or other reimbursement (whether or not you filed a claim) (see instructions)	300,000	2,000		
Note: If line 2 is more than line 3, skip line 4.					
4	Gain from casualty or theft. If line 3 is more than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.	165,000			
5	Fair market value before casualty or theft		5,000		
6	Fair market value after casualty or theft		2,000		
7	Subtract line 6 from line 5		3,000		
8	Enter the smaller of line 2 or line 7		3,000		
9	Subtract line 3 from line 8. If zero or less, enter -0-		1,000		
10	Casualty or theft loss. Add the amounts on line 9 in columns A through D				1,000
11	Enter the smaller of line 10 or \$100. But if the loss arose in the Hurricane Katrina disaster area after August 24, 2005; Hurricane Rita disaster area after September 22, 2005; or Hurricane Wilma disaster area after October 22, 2005, and was caused by that particular hurricane, enter -0-				100
12	Subtract line 11 from line 10				900
Caution: Use only one Form 4684 for lines 13 through 21.					
13	Add the amounts on line 12 of all Forms 4684				900
14	Add the amounts on line 4 of all Forms 4684				165,000
15	<ul style="list-style-type: none"> • If line 14 is more than line 13, enter the difference here and on Schedule D. Do not complete the rest of this section (see instructions). • If line 14 is less than line 13, enter -0- here and go to line 16. • If line 14 is equal to line 13, enter -0- here. Do not complete the rest of this section. 				* 164,100
16	If line 14 is less than line 13, enter the difference				
17	Add the amounts on line 12 of all Forms 4684 on which you entered -0- on line 11.				
18	Is line 17 less than line 16? <input type="checkbox"/> No. Stop. Enter the amount from line 16 on Schedule A (Form 1040), line 19. Estates and trusts, enter the amount from line 16 on the "Other deductions" line of your tax return. <input type="checkbox"/> Yes. Subtract line 17 from line 16.				
19	Enter 10% of your adjusted gross income from Form 1040, line 38. Estates and trusts, see instructions				
20	Subtract line 19 from line 18. If zero or less, enter -0-				
21	Add lines 17 and 20. Also enter the result on Schedule A (Form 1040), line 19. Estates and trusts, enter the result on the "Other deductions" line of your tax return				

For Paperwork Reduction Act Notice, see page 4 of the instructions.

Cat. No. 129970

Form **4684** (2006)

* See attached statement

2006 Workbook

Observations for Form 4684 in Example 13

1. Rich and Judy have a \$1,000 casualty loss on the furniture and a \$165,000 casualty gain on the home. **After deducting the \$100 floor, their net casualty gain is \$164,100 (line 15, Form 4684).**
2. The postponement of gain rules apply to the \$165,000 gain on the home. Those rules are irrelevant regarding the \$1,000 loss on the furniture.

The attached statement for line 15 of Form 4684 is **not shown**. The facts and computations that should be contained in the statement are explained below.

Excerpt from IRS Pub. 547, *Casualties, Disasters and Thefts (For Use in Preparing 2005 Returns)*:

Postponement of Gain. *If you have a gain on damaged property, you can postpone reporting the gain if you spend the reimbursement to restore the property.*

*To postpone reporting all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. **If the cost of the replacement property is less than the reimbursement, you must include the gain in income up to the amount of the unspent reimbursement.***

Rich and Judy spent \$208,000 to restore their vacation home after the fire as shown below.

Amount spent in 2006 on repairs and improvements to home	\$200,000
Cleanup expenses paid in 2006 (to clean and remove odor)	8,000
Total amount spent in 2006 to restore the home	\$208,000

The amount of the \$165,000 casualty gain on the home that is taxable for 2006 is \$92,000 as shown below.

Amount of insurance proceeds received for the home	\$300,000
Less: amount spent to restore home	(208,000)
Unspent amount which is taxable in 2006	\$ 92,000

The \$92,000 taxable gain is a long-term capital gain. The net gain of \$164,100 carries from line 15 of Form 4684 to Line 11 of Schedule D. An adjustment should be made in Part II of Schedule D for the amount of the gain that is, or will be, reinvested. The adjustment is calculated as shown below.

Net gain from Form 4684, line 15	\$164,100
Less: taxable gain	(92,000)
Adjustment (Schedule D, Part II, line 8)	\$ 72,100

A statement should be attached to the return which shows:

- The computation for the \$165,000 casualty gain on the home
- The computation for the \$92,000 taxable portion of the \$165,000 gain

2006 Workbook

For Example 13

SCHEDULE D (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>	Capital Gains and Losses ▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.	<small>OMB No. 1545-0074</small> <div style="font-size: 24px; font-weight: bold; text-align: center;">2006</div> <small>Attachment Sequence No. 12</small>
Name(s) shown on Form 1040 Rich and Judy		Your social security number 111 22 3333

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 Reinvested 4684 Gain	07/10/95	03/04/06		72,100	(72,100)
9 Enter your long-term totals, if any, from Schedule D-1, line 9		9			
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)		10			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					11 164,100
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					12
13 Capital gain distributions. See page D-1 of the instructions					13
14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your Capital Loss Carryover Worksheet on page D-7 of the instructions					14 ()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back					15 92,000

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H Schedule D (Form 1040) 2006

Other Observations for Example 13

1. The \$1,000 appraisal fee and the \$200 cost of photographs are treated identically as explained in Example 12.
2. Rich and Judy’s adjusted basis in the vacation home is now \$227,000 computed as follows:

Cost basis before fire	\$135,000
Plus: taxable gain in 2006	92,000
Adjusted basis	\$227,000

3. Rich and Judy have until December 31, 2008, to reinvest the remaining \$92,000 gain in replacement property. If they decide to do so after the return is filed, they can file an amended return for 2006.

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Casualty Loss to Trees

A frequent casualty loss issue is the damage or destruction of ornamental trees on residential personal use property. The numerous court cases in this area indicate that proving the following factual information is the key to determining the amount of any allowable casualty loss:

1. What was the actual decrease in fair market value **of the property as a whole** (residence + land + trees) immediately before and after the casualty?
2. What factor does the destruction of a tree or several trees play in determining the decrease in fair market value?

Court Case Analysis

From an analysis of court cases, it is evident that obtaining an appraisal soon after the casualty from a realtor familiar with local real estate values is valuable evidence. If this is done, the tax practitioner has documentary evidence to support the alleged decrease in fair market value of the property as a whole.

If an IRS examination results in an adjustment to the claimed casualty loss for trees, the Tax Court is likely to settle the disputed issue by allowing a loss that is between the figures shown in competing appraisals. See the *Bowers* case for an example.²⁶

Another way to measure the decline in fair market value without an appraisal is explained in IRS Pub. 17, *Your Federal Income Tax for Individuals (For use in preparing 2005 returns)*.

Excerpt from IRS Pub. 17:

The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in fair market value. You may be able to measure your loss by what you spend on the following:

- *Removing destroyed or damaged trees and shrubs.*
- *Pruning and other measures taken to preserve damaged trees and shrubs.*
- *Replanting necessary to restore the property to its approximate value before the casualty.*

The following two examples are contained in a May 2006 topic from the IRS website entitled “FAQs for Hurricane Victims.”

Example 14. A taxpayer lost a large tree in her backyard due to Hurricane Katrina, but sustained no other property damage. An arborist valued the damage to the tree at \$3,000. The taxpayer spent \$600 to remove the tree from the yard and grind the stump. Insurance paid \$500 for debris removal.

The value of the damage to the tree determined by the arborist does not qualify as a measure of the casualty loss because it does not reflect the decrease in the fair market value of the residential property as a whole, including the residence, land and improvements. The taxpayer may obtain an appraisal of the **entire** property to determine any decrease in value resulting from the loss of the tree.

Alternately, the taxpayer may use costs incurred to clean up and remove the tree as a measure of the decrease in the fair market value of the property — provided the costs are not excessive, are necessary to bring the property back to its condition before the casualty, take care of the damage only, and do not cause the property to be worth more than before the casualty. The taxpayer would subtract from the loss any insurance reimbursement for tree removal and clean-up expenses. **Under this alternative, the taxpayer has a casualty loss of \$100.** However, after the \$100 floor and 10% AGI adjustment, none of this loss is deductible.

²⁶ *Thomas R. and Theresa R. Bowers v. Commr.*, TC Memo 1981-658, November 12, 1981

Example 15. A taxpayer had a large tree that fell during Hurricane Rita and crushed a carport. Among many trees on the property, it was the only tree that was damaged. The loss of this tree does not affect the fair market value of the entire property. Homeowners' insurance reimbursed the taxpayer all costs for repairing the carport and removing the tree.

Insurance paid for all repair costs to bring the property back to its pre-casualty condition and value. **Therefore, the taxpayer has no casualty loss.**

PROBLEM 4: LEGAL FEES

BACKGROUND INFORMATION

The issue of whether legal fees are deductible is a highly litigated one. Generally, legal fees can be deducted under two IRC sections:

- **IRC §212. Expenses for the Production of Income.** These legal fees are usually allowable only as a miscellaneous itemized deduction subject to the 2% of AGI limitation.
- **IRC §162. Trade or Business Expenses.** These legal fees are allowable on the appropriate business form or schedule for ordinary and necessary legal expenses.

Another code section which can be applied in determining the disallowance of legal fees is IRC §262. It expressly disallows legal fees associated with personal, living, and family expenses.

IRC §212: Expenses for the Production of Income

This code section is one of the shortest of all code sections.

"In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

- *for the production or collection of income;*
- *for the management, conservation, or maintenance of property held for the production of income; or*
- *in connection with the determination, collection, or refund of any tax."*

Explanation of IRC §212(3). Where to deduct legal and professional fees paid "in connection with the determination, collection, or refund of any tax" varies with the type of tax services rendered. **The table below summarizes where on the return tax advice and tax return preparation expenses should be deducted.**²⁷

Advice Related to	Where the Deduction Is Claimed
Nonbusiness tax issues	Schedule A (Miscellaneous itemized deduction)
Business tax issues (including rentals)	On the appropriate form or schedule (Schedule C, F, or E)

The phrase "any tax" is very broad. It includes any federal income, estate, or gift tax. It also includes state or local income taxes and property taxes.

The Treasury regulations for IRC §212 are also very brief. As a result, the interpretation of IRC §212 has evolved from numerous court cases.

²⁷ Rev. Rul. 92-29, 1992-1 CB 20

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Sampling of Court Cases

The following is a sampling of various court cases concerning whether the legal fees were deductible under IRC §§162 or 212, or nondeductible under IRC §262.

1. A husband could not deduct legal fees relating to his divorce under the **origin and character of the claim** test. The purpose for the husband's divorce litigation arose from the marital relationship, not from the business activity of his three corporations.²⁸
2. A doctor attempted to bribe a U.S. District Court judge to vacate the one-year prison sentence previously ordered by the judge for willful tax evasion. If convicted of "obstruction of justice" due to the bribe attempt, the doctor would lose his medical license under Wisconsin law. His legal fees in defending the "obstruction of justice" charge were not allowable either as a:
 - §212 expense for the production of income, or
 - §162 ordinary and necessary business expense.

The legal fees were held to be a nondeductible personal expense under IRC §262.²⁹

3. A securities dealer who specialized in underwriting the public sale of stock was convicted of mail fraud under federal law. He was allowed to deduct his legal fees as a business expense under IRC §162 even though he was convicted, fined, and sentenced to prison.³⁰
4. A husband paid \$2,500 to his wife's attorney for legal expenses she incurred in the divorce and property settlement. The \$2,500 was characterized by the wife's attorney as a fee "for tax advice regarding the property settlement." The husband was not allowed to deduct the \$2,500 he paid to his wife's attorney. That fee, even though paid in connection with the "determination ... of any tax," as defined in IRC §212(3), did not relate to determining the tax liability of the **taxpayer**.³¹
5. A woman was not allowed to deduct the legal fee for her divorce. She contended that her divorce attorney was unsuccessful in obtaining alimony. The court noted that she failed to prove how much, if any, of her legal fee was allocable to trying to secure alimony. Therefore, the entire legal fee was a nondeductible personal expense under IRC §262.³²
6. A husband paid \$10,000 to his divorce attorney. An IRS exam determined that only \$500 of that fee was deductible under IRC §212(3) as an expense paid for federal income tax advice. The court allowed a deduction of one third of the \$10,000 based on the law firm's ledger sheets and testimony of one of the firm's partners.³³
7. An attorney was not allowed to deduct a \$5,600 legal fee paid in his attempt to gain admission to the California Bar. Even though he had passed the California Bar exam, a Bar committee of California had denied his admission due to moral character charges previously instituted by the Florida Bar. The court denied any deduction of the legal fees as either:
 - A business expense under IRC §162, or
 - An expense under IRC §212(1) for the "production or collection of income."

²⁸ *U.S. v. Don Gilmore*, Supreme Court, 372 U.S. 39, February 18, 1963

²⁹ *Milton and Betty Margoles v. Commr.*, TC Memo, 1968-58, April 8, 1968

³⁰ *Walter F. Tellier*, Supreme Court, 383 U.S. 687, March 24, 1966

³¹ *Thomas C. Davis*, Supreme Court, 370 U.S. 65, 82 S Ct.60, June 4, 1962

³² *Helen Kellner v. Commr.*, United States Court of Appeals (2d Cir.), No. 76-4193, February 3, 1977

³³ *G. Munn, Jr. v. U.S.*, U.S. Court of Claims, No. 76-68, February 18, 1972

The court, citing the “**origin and character of the claim**” precedent set in the *Gilmore* Supreme Court case (see #1 above), noted the following: “While the taxpayer’s primary purpose for bringing suit might have been to protect his job and business reputation, his motives for initiating the process are not considered. The legal expenses in question arose out of action to gain admission to the California Bar. These costs are treated as Bar admission expenses and are, therefore, nondeductible under either §§162 or 212.”³⁴

8. The taxpayer deducted his entire \$2,100 legal fee for estate planning as an itemized deduction for tax advice “in connection with the determination of any tax.”³⁵ The legal work performed included will preparation and the creation of two trusts. An IRS exam disallowed all of it since the legal bill did not include an itemization of services or the time spent on each activity. The court noted that it was difficult to determine how much of the fee was allocable to tax advice. Therefore, the court allowed a deduction of 20% of the \$2,100 fee.³⁶
9. The taxpayers’ rural Arkansas land was condemned by the federal government. The taxpayers paid \$7,258 of legal fees to both prevent the condemnation and to litigate the amount of the condemnation award. The \$37,600 litigated award was received in 1975 and the taxpayers then bought replacement property that cost more than the net award amount. On their 1975 tax return, no gain was reported on Schedule D. However, the entire \$7,258 legal fee was claimed as an itemized deduction as an expense paid “for the management, conservation, or maintenance of property held for the production of income.”³⁷

The court held that the legal fees to **prevent the condemnation** represented a capital expense under IRC §263. They were not deductible under IRC §212(2). The origin and character of the litigation was capital in nature. Therefore, the legal fees are treated in a similar manner for tax purposes.

The legal fees paid to **obtain the condemnation award** were deducted from the award in determining the net amount realized on conversion.³⁸

10. The taxpayer paid a \$1,200 legal fee in a child custody suit brought against his ex-wife who was granted custody in the divorce. The \$1,200 was deducted as an itemized deduction on the 1970 tax return. Both the IRS and the court held that the fee was a nondeductible personal, living, or family expense under IRC §262.³⁹

LEGAL COSTS FOR A DIVORCE

The deductibility of legal fees relating to divorce is a frequently disputed issue. Individuals generally cannot deduct the legal fees and court costs incurred in a divorce. **However, parties to a divorce may deduct the cost of legal fees for:**

- Tax advice regarding the divorce, and
- For obtaining alimony.

In addition, fees paid to appraisers, actuaries, and accountants for determining the correct tax, or for helping to obtain alimony, may also be deductible.

The attorney or tax professional must separately identify deductible fees in their bills. The taxpayer cannot arbitrarily make the allocation for tax-related issues. The **amount and specific tax issue** must be clearly identified in the bill.

³⁴ *Merrell and Francine Vannier v. Commr.*, TC Memo 1997-370, August 13, 1997

³⁵ IRC §212(3)

³⁶ *Sidney and Susan Merians v. Commr.*, 60 TC 187, May 8, 1973

³⁷ IRC §212(2)

³⁸ *Joel and Gerean Wallace v. Commr.*, TC Memo 1984-277, May 23, 1984

³⁹ *John G. McDonald, Jr. and Barbara A. McDonald v. Commr.*, TC Memo 1973-108, May 7, 1973

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The following billing descriptions are examples of the precise wording necessary to deduct the cost of services performed by a client's divorce attorney:

1. Analysis of Separate Maintenance Order to determine deductibility of payments made on behalf of the estranged spouse for income tax purposes
2. Review of Child Support Order to determine whether the child qualifies as a dependent and whether a waiver via Form 8332 to release the dependent is required
3. Review of marital assets for tax consequences of possible liquidation
4. Review of marital assets in the proposed property settlement to determine whether the ex-spouse provided adequate and correct basis information for income tax purposes
5. Planning regarding structuring the payment of alimony to ensure it can be deducted for income tax purposes
6. Analysis to determine the tax cost of receiving alimony
7. Appraisal cost incurred to determine the taxable gain on the eventual sale of property received in the proposed property settlement
8. Expert witness fees for testimony regarding the tax cost of property settlements, alimony, or child support

Any deductible fees are reported on line 22 of Schedule A as miscellaneous deductions. They are subject to the 2% of AGI limitation. See Rev. Rul. 72-545 for more information about situations in which legal fees for advice concerning tax consequences incident to a divorce are deductible.

Note. See Chapter 1, "Divorce," for other tax issues related to divorce.

CONTINGENT ATTORNEY FEES

The Supreme Court's decision in the *Banks* case⁴⁰ settled the disputed issue of whether contingent attorney fees are includable in the gross income of successful litigants. **The Supreme Court held that they are.**

After full inclusion in AGI, the attorney fees are normally deductible on Schedule A as a miscellaneous deduction subject to the 2% of AGI limitation. This rule usually results in AMT liability for the recipient in the year any large taxable damage award is received.

An exception to the general rule was created by a provision of the American Jobs Creation Act of 2004. An adjustment in arriving at AGI is allowed for any legal fees paid in connection with **unlawful discrimination** lawsuits.⁴¹ All such legal fees, including those not paid under a contingency agreement are eligible for the AGI adjustment.

- Taxpayers are allowed a deduction for attorney fees and court costs paid in connection with any actions involving a "claim of unlawful discrimination" in arriving at AGI.
- The allowable deduction applies to fees and costs paid after October 22, 2004.
- The deduction in arriving at AGI applies only to court judgments or settlements **received after October 22, 2004.**

A detailed listing of what constitutes a "claim of unlawful discrimination" is found in IRC §62(e), entitled "**Unlawful discrimination defined.**"

⁴⁰ *Commr. v. John W. Banks II*, Supreme Court, No. 03-892, January 24, 2005; and page 522 of the 2005 *University of Illinois Federal Tax Workbook*

⁴¹ IRC §62(a)(20)

Example 16. Wendy, who is physically handicapped, sued her former employer for alleged unlawful discrimination. Her lawsuit claimed that her dismissal was illegal under a provision of the Americans with Disabilities Act of 1990. The terms of her contingent fee agreement with her attorney provided that she was entitled to keep 70% of any eventual court judgment amount. Her attorney would retain 30% of the award as payment for his legal services.

The suit began in 2004 and an out-of-court settlement with the former employer was finalized in May 2006. Wendy's former employer agreed to pay \$200,000 of back wages to settle the lawsuit. A 2006 Form W-2 was issued to Wendy for the \$200,000. Wendy paid no out-of-pocket legal expenses prior to the settlement.

Tax Result for Example 16. Wendy reports the \$200,000 of back wages on line 7 on her 2006 Form 1040. Her contingent attorney fee of \$60,000 is deducted on line 36 of Form 1040 as a write-in adjustment with "UDC—60,000" written on the dotted line next to line 36.

Observations for Example 16

1. The write-in identification "UDC" on the dotted line next to line 36 on Wendy's 1040 is an abbreviation for "Unlawful Discrimination Claims." This is explained in the 2006 Form 1040 instructions.
2. Assume that Wendy claims the \$5,150 standard deduction. As a result of the favorable law change, Wendy owes no AMT for 2006.
3. Assume, similar facts except that Wendy's lawsuit involved alleged securities fraud by her former broker instead of a claim of unlawful discrimination. If so, any contingent attorney fees she pays for a settlement of that lawsuit are deductible only as a miscellaneous itemized deduction on Schedule A. In that case, Wendy likely has a 2006 AMT liability due to the AMT adjustment for miscellaneous itemized deductions.

Note. See Letter Ruling 200550004 in the "Deductions" section of Chapter 15, "Rulings and Cases" for more information on this topic.

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For Example 16

Form	1040	Department of the Treasury—Internal Revenue Service	U.S. Individual Income Tax Return	2006	(99) IRS Use Only—Do not write or staple in this space.		
		For the year Jan. 1–Dec. 31, 2006, or other tax year beginning _____, 2006, ending _____, 20		OMB No. 1545-0074			
Label (See instructions on page 16.) Use the IRS label. Otherwise, please print or type. Presidential Election Campaign	L A B E L H E R E	Your first name and initial Wendy	Last name	Your social security number 111 11 111			
		If a joint return, spouse's first name and initial	Last name	Spouse's social security number			
		Home address (number and street). If you have a P.O. box, see page 16.		Apt. no.		▲ You must enter your SSN(s) above. ▲	
		City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.		Checking a box below will not change your tax or refund.			
Presidential Election Campaign		Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16)		<input type="checkbox"/> You <input type="checkbox"/> Spouse			
Filing Status		1 <input checked="" type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶ 4 <input type="checkbox"/> Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 <input type="checkbox"/> Qualifying widow(er) with dependent child (see page 17)					
Exemptions		6a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a b <input type="checkbox"/> Spouse		Boxes checked on 6a and 6b No. of children on 6c who: • lived with you _____ • did not live with you due to divorce or separation (see page 20) _____ Dependents on 6c not entered above _____ Add numbers on lines above ▶ 1			
		c Dependents:					
		(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you		
					(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 19)		
If more than four dependents, see page 19.							
d		Total number of exemptions claimed					
Income		7 Wages, salaries, tips, etc. Attach Form(s) W-2		7	200,000		
		8a Taxable interest. Attach Schedule B if required		8a	5,000		
		b Tax-exempt interest. Do not include on line 8a		8b			
		9a Ordinary dividends. Attach Schedule B if required		9a			
		b Qualified dividends (see page 23)		9b			
		10 Taxable refunds, credits, or offsets of state and local income taxes (see page 23)		10			
		11 Alimony received		11			
		12 Business income or (loss). Attach Schedule C or C-EZ		12			
		13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/>		13			
		14 Other gains or (losses). Attach Form 4797		14			
		15a IRA distributions		15a			
		b Taxable amount (see page 25)		15b			
		16a Pensions and annuities		16a			
		b Taxable amount (see page 25)		16b			
		17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	9,000		
		18 Farm income or (loss). Attach Schedule F		18			
		19 Unemployment compensation		19			
		20a Social security benefits		20a			
		b Taxable amount (see page 27)		20b			
		21 Other income. List type and amount (see page 29)		21			
		22 Add the amounts in the far right column for lines 7 through 21. This is your total income ▶		22	214,000		
Adjusted Gross Income		23 Archer MSA deduction. Attach Form 8853		23			
		24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ		24			
		25 Health savings account deduction. Attach Form 8889		25			
		26 Moving expenses. Attach Form 3903		26			
		27 One-half of self-employment tax. Attach Schedule SE		27			
		28 Self-employed SEP, SIMPLE, and qualified plans		28			
		29 Self-employed health insurance deduction (see page 30)		29			
		30 Penalty on early withdrawal of savings		30			
		31a Alimony paid b Recipient's SSN ▶		31a			
		32 IRA deduction (see page 31)		32			
		33 Student loan interest deduction (see page 33)		33			
		34 Jury duty pay you gave to your employer		34			
		35 Domestic production activities deduction. Attach Form 8903		35			
		36 Add lines 23 through 31a and 32 through 35		UDC - 60,000	36		
		37 Subtract line 36 from line 22. This is your adjusted gross income ▶		37	154,000		

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 78.

Cat. No. 11320B

Form **1040** (2006)

PROBLEM 5: STATE AND LOCAL INCOME TAX REFUNDS

GENERAL RULES

Refunds, credits, or offsets of state and local income taxes received in 2006 must generally be included as income on line 10 of the 2006 Form 1040 if the tax was paid and deducted in a prior year. This includes refunds resulting from taxes that were:

- Overwithheld
- Not computed correctly
- Computed again because of an amended return

The payer should send a 2006 Form 1099-G, *Certain Government Payments*, to the recipient by January 31, 2007.

A worksheet entitled “State and Local Income Tax Refund Worksheet — Line 10” in the 2006 Form 1040 instructions can generally be used to compute the amount of the taxable 2005 state income tax refund received in 2006. This worksheet can generally be used if three conditions are met:

1. The refund received in 2006 is for a state (or local) income tax paid in 2005.
2. Itemized deductions were claimed in 2005 rather than the standard deduction.
3. State (or local) **income** taxes were deducted on the 2005 Schedule A instead of state and local **sales** taxes.

Note. The taxable refund amount is limited to the total of itemized deductions claimed in 2005 that are in **excess** of the allowable 2005 standard deduction. The worksheet considers this limitation in arriving at the taxable amount of the refund for 2006.

Example 17. Carol itemized deductions on her 2005 tax return. She deducted \$3,000 of state income taxes on her 2005 Schedule A. Her allowable sales tax deduction for 2005 would have been \$1,500. In 2006, she received a state income tax refund of \$400.

Tax result for Example 17. The \$400 refund is taxable in 2006. It will be entered on line 10 on Carol’s 2006 Form 1040.

Beginning in 2004, taxpayers could choose to deduct the **larger** of:

- State and local **income** taxes
- State and local **sales** taxes

For 2005 and 2006 tax returns, the taxable amount of the state and local **income** tax refunds is limited to the excess of the tax that was actually deducted over the **sales** taxes that could have been deducted.

Example 18. Greg chose to deduct \$5,000 of Illinois income tax on his 2005 Schedule A rather than \$4,000 of state and local sales taxes. In 2006, Greg received a state income tax refund of \$1,500 of overpaid 2005 Illinois state income tax.

Tax Result for Example 18. Only \$1,000 of the \$1,500 state income tax received is taxable on Greg’s 2006 Form 1040.

State income tax actually deducted on the 2005 Schedule A	\$5,000
Less: amount of sales taxes that could have been deducted on the 2005 Schedule A	<u>(4,000)</u>
Excess of what was deducted over what could have been deducted	\$1,000

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EXCEPTIONS TO USING WORKSHEET INCLUDED IN FORM 1040 INSTRUCTIONS

If any of the following exceptions apply, the worksheet found in the 2006 Form 1040 instructions cannot be used to compute the amount of the taxable refund.

1. The refunded tax received in 2006 was claimed as an itemized deduction in 2005 but **no tax benefit was received in 2005 because AMT was owed on the 2005 return.**
2. The refunded tax received in 2006 was claimed as an itemized deductions in 2005 and **the total 2005 itemized deductions were reduced by 3% of AGI.**
3. The refunded tax received in 2006 **is attributable to a tax year other than 2005.**
4. The taxpayer who received the refunded tax in 2006 **was claimed as a dependent by someone else in 2005.**
5. The last 2005 estimated state income tax payment was made in 2006.
6. The refunded tax received in 2006 is **more** than the amount by which the 2005 Schedule A deduction for state (or local) income taxes **exceeds** the amount that could have been deducted for state and local sales tax.

Note. See **Example 18** for details.

If any of the exceptions apply, Worksheet 2 from IRS Pub. 525, *Taxable and Nontaxable Income*, should be used to compute the taxable amount of the refunded tax received in 2006.

Note. Many tax software programs automatically perform the calculations for these exceptions **if** the input data is accurate and complete.