Chapter 1: Individual Taxpayer Issues

Please note. Corrections were made to this workbook through January of 2017. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

INNOCENT SPOUSE RELIEF

Generally, married couples filing jointly (MFJ) are jointly and severally liable for any tax associated with the tax year.[1] Accordingly, one spouse is generally liable for any tax attributable to the other spouse that arises from failure to report income items or claiming inappropriate deductions (whether intentional or not). Frequently, one spouse becomes liable for the tax attributable to items concealed by the other spouse.

Congress enacted IRC §6015 as part of the Internal Revenue Service Restructuring and Reform Act of 1998,[2] to provide relief under certain circumstances to a spouse from the joint and several tax liability that accompanies a joint return. Under the current innocent spouse provisions, a spouse that **meets certain requirements** may obtain relief from the joint and several tax liability associated with an MFJ return.

Generally, IRC §6015 provides **three** options for a spouse seeking such relief. These three options and the guidance for each option are summarized in the following table.

Relief Option	Tax Code Section	Regulatory Guidance	Application
General relief	IRC §6015(b)	Treas. Reg. §1.6015-2	Limited to understatements of tax attributable to the nonrequesting spouse's tax items
Allocation relief	IRC §6015(c)	Treas. Reg. §1.6015-3	Limited to deficiencies (underpayments) allocable to the nonrequesting spouse
Equitable relief	IRC §6015(f)	Treas. Reg. §1.6015-4	Applies to any unpaid tax or deficiency (inluding an underpayment of tax) and may also be used to obtain a refund under certain circumstances

Note. The relief provided under the above options is determined without regard to any community property laws that may otherwise apply to one or both spouses.[3]

1. IRC §6013(d)(3); *Butler v. Comm'r*, 114 TC 276 (2000).
2. PL 105-206.
3. IRC §6015(a).

Each option has certain requirements that must be met before relief is granted. A spouse requesting relief from joint and several tax liability may submit a single claim using the provisions of both IRC §§6015(b) and (c). However, equitable relief under §6015(f) is available only to a requesting spouse who **does not** qualify for relief under **either** IRC §6015(b) or (c).

All three options and their respective requirements are discussed in this section.

GENERAL RELIEF

Under IRC §6015(b), a requesting spouse is eligible for relief from joint and several tax liability if **all** the following requirements are met.[4]

- A joint return was filed for the tax year covered by the request (the **joint return requirement).**
- The return has a tax understatement due to erroneous items attributable to the other spouse (the **understatement requirement).**
- The requesting spouse establishes that they did not know (or have reason to know) about the understatement of tax (the **knowledge requirement).**
- Under all the facts and circumstances, holding the requesting spouse liable for the tax is inequitable (the **inequitable requirement).**
- The requesting spouse makes the request for relief no later than two years from the date that the IRS commences collection activity against the requesting spouse (the **deadline requirement).**

Joint Return Requirement

Because innocent spouse relief provides relief from joint and several tax liability, a prerequisite to the availability of innocent spouse relief under IRC §6015(b) is the filing of a joint return.[5] In some cases, it must be determined whether the return filed was a joint return.

IRC §6013 allows spouses to elect to file a joint return. Generally, IRS guidance indicates that a joint return requires the signatures of both spouses.[6] However, the courts have held that a joint return was filed when the married taxpayers intended to file a joint return, regardless of whether both signed it.[7] A facts and circumstances analysis may also be applied by a court when determining whether a joint return was filed.

> **Example 1.** Bob and Shirley are married, both signed an MFJ tax return, and it was filed. The only reason Shirley signed the return is that she felt obligated to because she assisted Bob in preparing parts of it. She did not intend to file a joint return with Bob, and only Bob's name was listed at the top of the return. A joint return provided her with no advantage for the tax year.
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> The court determined, under these facts and circumstances, that the return is not a joint return. Shirley is not jointly and severally liable for Bob's tax liability for the year.[8]

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4. IRC §6015(b)(1).
5. IRC §§6015(b)(1)(A) and (c)(1).
6. Treas. Reg. §1.6013-1(a)(2).
7. *Heim v. Comm'r*, 251 F.2d 44 (8th Cir. 1958); *Kiesling v. U.S.*, 171 F.Supp. 314 (S.D. Texas, 1958).
8. This example is based on the facts in *Payne v. U.S.,* 247 F.2d 481 (8th Cir. 1957), *cert. denied* 355 U.S. 923.

In a facts and circumstances analysis, the courts frequently hold that a joint return exists if only one spouse signs the return (or also signs for the other spouse without their consent) if the facts indicate that the nonsigning spouse gave **tacit consent** to filing a joint return. It has been held that tacit consent exists when the nonsigning spouse does not file a separate return and knows the other spouse is filing a return. This is particularly true if the nonsigning spouse permits their income to be shown on the return and understands that there is a legal obligation to file a return and report the income.[9]

Apparent tacit consent from a nonsigning spouse may create the presumption that a joint return was filed. Apparent tacit consent may exist if the nonsigning spouse neither objects to the filing of the return nor files a separate return.[10] However, if one spouse does not sign the return, the other spouse (or other party) seeking to establish that there was a joint return (to invoke joint and several liability for taxes) has the burden of proving that a joint return was filed.[11]

Case law indicates that the nonsigning spouse may refute that they gave tacit consent by establishing that they refused to sign the return, by filing a separate return, or by proving a lack of knowledge that a joint return was filed.[12]

A history of the spouses filing jointly may also be a factor in finding that a joint return was intended.[13] However, changed circumstances between the spouses, such as divorce or contemplation of divorce, may result in a narrow application of the tacit-consent rule even if the spouses have a consistent history of joint filing.[14]

> **Note.** Cases that determine whether a joint return exists are frequently decided on very specific facts. Similar patterns of facts have led to different case outcomes. This is often a difficult question for the courts to resolve.

Example 2. Fred and Sandra both signed and filed an MFJ return. However, in Tax Court, Sandra testified that she only signed it because she thought she was obligated to do so. She had helped Fred complete the return, even though her name was not on it. Sandra was a homemaker and had no source of income in her own name. She did not file a married filing separately (MFS) return. The Tax Court held that no joint return existed.[15]

Example 3. Bill and Carol were separated in 2014. An MFJ return was prepared for both spouses for 2014, but Carol refused to sign it. However, Carol did not file an MFS return, and she knew that Bill was filing the MFJ return. The Tax Court held that a joint return existed for Bill and Carol for 2014 because Carol tacitly consented to filing the joint return even though she did not sign it.[16]

One important factor the courts use in determining **tacit consent** is whether at the time of filing the spouses **intended** to file jointly. The "existence of tax agreement clause" in a divorce decree between the spouses is another factor frequently considered by the courts as proof of intent.

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9. *Heim v. Comm'r*, 251 F.2d 44 (8th Cir. 1958); *Klayman v. Comm'r*, TC Memo 1979-408 (Sep. 27, 1979); *Streit v. Comm'r*, TC Memo 1989-265 (Jun. 1, 1989).
10. *Howell v. Comm'r*, 10 TC 859 (1948), *aff'd per curiam,* 175 F.2d 240 (6th Cir. 1949); *Hennen v. Comm'r,* 35 TC 747 (1961).
11. *Parker v. Comm'r*, TC Memo 1978-23 (Jan. 19, 1978); *Ashworth v. Comm'r*, TC Memo 1990-423 (Aug. 7, 1990).
12. *Spheeris v. Comm'r,* TC Memo 1969-43 (Feb. 27, 1969); *Springmann v. Comm'r,* TC Memo 1987-474 (Sep. 21, 1987); *Walsh v. U.S.* (D. Minn. 1985); *Groves v. Comm'r,* TC Memo 1957-196 (Oct. 17, 1957); *McCanless v. Comm'r*, TC Memo 1987-573 (Nov. 18, 1987).
13. *S. Presley, Sr. v Comm'r*, TC Memo 1979-339 (Aug. 27, 1979); *Gaviola v. Comm'r*, TC Memo 1986-349 (Aug. 5, 1986).
14. *Walsh v. U.S.* (D. Minn. 1985).
15. Based on *Payne v. U.S.*, 247 F.2d 481 (8th Cir. 1957), *cert. denied* 355 U.S. 923.
16. Based on *Streit v. Comm'r*, TC Memo 1989-265 (Jun. 1, 1989).

Example 4. Clark and Jane were separated in 2014 and divorced in 2015. They did not communicate with each other for many months. Clark lived in Texas, and Jane resided in California. Their divorce resulted in a marital settlement agreement with a clause indicating that both spouses intended to file MFJ for 2014. Clark subsequently filed a 2014 MFJ return for both spouses without Jane's signature. Despite Jane's challenge to the unsigned return, the Tax Court held that a valid joint return existed because of the marital settlement agreement clause.[17]

Substitute Returns. Under certain circumstances, the IRS may prepare **substitute returns** for taxpayers. In accordance with IRC §6020(a), the IRS may prepare a valid return for a married couple who consent to disclose the necessary tax information and sign the IRS-prepared return. If both spouses sign the return and express their intentions to file jointly, a valid joint return has been created.[18]

In addition, the IRS may prepare a joint return based on the information available to it for a couple who fails to file a return and who neither provide the necessary information nor sign the return.[19] This is not a valid joint return because it is an IRS-created document that was not signed by the spouses under penalties of perjury and cannot be considered a valid election to file jointly under IRC §6013.[20]

Understatement Requirement

To be eligible for innocent spouse relief, the joint return must include an understatement of tax due to some error (either intentional or unintentional) made by the nonrequesting spouse. For purposes of the innocent spouse rules, the term **understatement** means that the correct amount of tax that should have been shown on the return for the year exceeds the amount that was actually shown on the return.[21]

> **Note.** This definition of **understatement** is also used for purposes of the accuracy-related penalty.

Knowledge Requirement

A requesting spouse is considered to have knowledge of, or reason to know of, an understatement if they have actual knowledge of the understatement or if a reasonable person in similar circumstances could be expected to have known about the understatement.[22] If the IRS establishes that the requesting spouse had actual knowledge of the understatement at the time they signed the return, the spouse will **not qualify** for relief under IRC §6015(b).[23]

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17. Based on *Douglass v. Comm'r*, TC Memo 1984-369 (Jul. 19, 1984).
18. Rev. Rul. 2005-59, 2005-37 IRB 505.
19. IRC §6020(b).
20. Rev. Rul. 2005-59, 2005-37 IRB 505.
21. Treas. Reg. §1.6015-2(b), referencing IRC §6662(d)(2)(A).
22. Treas. Reg. §1.6015-2(c).
23. Treas. Reg. §1.6015-2(c), referencing Treas. Reg. §1.6015-3(c)(2).

To determine whether a spouse **had reason to know** of the understatement, a facts and circumstances analysis is used.[24] The factors in such an analysis include, but are not limited to, the following.[25]

- The nature of the erroneous item on the return
- The amount of the erroneous item compared with the amounts of other items on the return
- The financial circumstances of the spouses
- The business background and education of the spouse requesting relief
- The extent to which the requesting spouse participated in the activity to which the understated tax liability is attributable
- Whether a reasonable person would have inquired of the other spouse about the errors on the return before or at the time of signature
- Whether the errors on the return leading to the understatement represented a departure from a recurring pattern reflected on prior years' returns filed by the spouses

The Tax Court has indicated that a requesting spouse has knowledge or reason to know of the understatement if a reasonably prudent taxpayer, under the circumstances that existed at the time of signing the return, could be expected to know of the erroneous tax liability or if the circumstances warranted further investigation.[26]

Example 5. Steve and Martha filed joint returns for the 2009 through 2015 tax years. The returns were completed primarily by Martha. From 2009 through 2015, Steve received commissions from several companies, including Andy's Sales Warehouse (Andy's), for his work as a salesperson.

Steve's commissions from Andy's were reflected on the 2014 return, but the return did not show any other commission income earned by Steve that year. In 2016, the IRS determined that the tax shown on the 2014 return was understated. In 2016, Steve and Martha were divorced. Martha requested relief from joint and several tax liability for the 2014 understatement under IRC §6015(b). She claimed that she did not know about the understatement.

Because Martha typically prepared the spouses' returns during their marriage, she **was aware of a pattern** of reporting commission income received by Steve from several companies each year. Accordingly, the Tax Court determined that a reasonably prudent taxpayer in Martha's position would **have reason to know** that the tax liability was understated. Because the circumstances indicated that further investigation was warranted, Martha was disqualified from IRC §6015(b) relief because she had reason to know of the omission.[27]

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24. Treas. Reg. §1.6015-2(c).
25. Ibid.
26. *Stevens v. Comm'r,* 872 F.2d 1499 (11th Cir. 1989).
27. Based on *Howerter v. Comm'r*, TC Summ. Op. 2014-15 (Feb. 19, 2014).

Under the applicable rules, a requesting spouse's knowledge about the receipt of unreported income precludes relief.[28] Joint ownership of the asset from which the error arose is a factor indicative of knowledge by both spouses. Generally, erroneous tax items attributable to jointly held property are allocable on a 50/50 basis between the spouses.[29] For spouses in a community property state, however, a spouse may not be considered a joint owner solely because of the state's community property laws. Instead, that spouse's name must appear on title documents or there must be some other indication that the spouse exercised a degree of dominion and control over the asset that demonstrates ownership.[30]

> **Note.** The IRS may rely on joint ownership to demonstrate that the requesting spouse has knowledge about the erroneous item. However, the IRS has the burden of demonstrating that the requesting spouse had actual knowledge and must do so by a preponderance of evidence to invalidate the request for innocent spouse relief.[31]

If the understatement is the result of an erroneous deduction or tax credit, the requesting spouse will be disqualified from innocent spouse relief if they know the deduction or credit was not allowable under the circumstances. However, for a fictitious or inflated deduction, the IRS must prove the requesting spouse had actual knowledge that the expense was not incurred to the extent claimed.[32] The IRS may prove that a requesting spouse had **actual** knowledge of an erroneous item at the time of signing a return by relying on all relevant facts and circumstances, including the following.[33]

- Deliberate efforts by the requesting spouse to avoid learning about the item to prevent liability
- Joint ownership of the property to which the return error is traceable

> **Observation.** Frequently, innocent spouse cases are held in favor of the IRS because the requesting spouse had knowledge about the erroneous items or participated in the activity that generated unreported income.[34]

Exception to Actual-Knowledge Requirement.[35] Although actual knowledge generally precludes innocent spouse relief, an exception applies if the requesting spouse establishes that they were the **victim of domestic abuse** before the return was signed and did not challenge known errors on the return because of their fear of retaliation.

> **Example 6.** Use the same facts as **Example 5,** except Martha established that she had been physically abused by Steve since 2012. She did not ask Steve questions about any additional 2014 commission income because she was afraid to do so. Even though Martha may otherwise have had reason to know of the omitted income, this does not prevent her from obtaining relief from joint and several tax liability.

Generally, knowledge of only the source of income or deduction is not sufficient to deny relief.[36] Moreover, if a requesting spouse had knowledge about only a portion of an erroneous item, they may obtain partial relief.[37]

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28. Treas. Reg. §1.6015-3(c)(2)(i)(A).
29. Treas. Reg. §1.6015-3(d)(5), Example 3.
30. Treas. Reg. §1.6015-3(c)(2)(iv).
31. Treas. Reg. §1.6015-3(c)(2).
32. Treas. Reg. §1.6015-3(c)(2)(i)(B).
33. Treas. Reg. §1.6015-3(c)(2)(iv).
34. See *Agudelo v. Comm'r,* TC Memo 2015-124 (Jul 7, 2015).
35. Treas. Reg. §1.6015-3(c)(2)(v).
36. Ibid.
37. Treas. Reg. §1.6015-3(c)(2)(iii).

Example 7. Karla requested §6015(b) relief from joint and several tax liability arising from the 2014 MFJ return filed with her spouse, Kevin. The tax on the 2014 return was understated because Kevin did not report a $3,000 dividend received in February 2014 and a $7,000 dividend received in December 2014. Karla knew that Kevin received the February dividend, but she did not know about the December dividend. Karla may obtain relief from the tax liability attributable to the December dividend but not the February dividend.

Inequitable Requirement[38]

To qualify for relief under IRC §6015(b), it must be inequitable to hold the requesting spouse jointly and severally liable for the tax under all the relevant facts and circumstances. Whether the requesting spouse **significantly benefitted,** directly or indirectly, from the understatement is one of the factors considered.

A **significant benefit** exists if the spouse received any benefit in excess of normal support. Evidence of direct or indirect benefit includes **transfers of money or property,** even years after the year of the understatement. If a requesting spouse receives money or property that is traceable to income items omitted by the other spouse on the return, this generally constitutes a significant benefit that disqualifies the requesting spouse from relief.

Other factors that may be considered include:[39]

- Whether the requesting spouse has been **deserted by** the nonrequesting spouse,
- Whether the spouses are **divorced or separated,** or
- Whether the requesting spouse **received a benefit** on the tax return from the understatement.

Example 8. Norman and Danielle divorced in 2016. Danielle is seeking relief from the joint and several liability relating to the MFJ return filed for the 2014 tax year. There was a substantial understatement of tax on the 2014 return due to Norman's failure to report a capital gain from an offshore account.

Danielle did not know about the offshore account, but Norman deposited the capital gain of $120,000 into their joint checking account. This deposit amount was unusually high for their otherwise modest checking account balance, which averaged approximately $5,000 throughout a typical year. Danielle purchased a new wardrobe using $10,000 from these funds. In addition, Danielle and Norman's divorce settlement stipulated that the remaining amount of gain proceeds would be split equally between them.

Under the facts and circumstances, it is not likely that Danielle will obtain innocent spouse relief under §6015(b). Norman's deposit of the capital gain amount to their joint checking account is very likely sufficient to indicate that Danielle knew about the resulting understatement of tax from failure to report the gain amount.

In addition, Danielle also received money from Norman beyond the amount of normal support and in a manner traceable to the omitted gain that was not reported on the 2014 MFJ return. The division of that gain as part of their 2016 divorce settlement represented an additional significant benefit to Danielle. Accordingly, it is unlikely that Danielle will be granted relief from joint and several tax liability for 2014.

Note. For further guidance on circumstances in which it may be inequitable to hold a requesting spouse liable when the spouse has received a significant benefit from the understatement, see Treas. Reg. §1.6015-2(d).

38. Treas. Reg. §1.6015-2(d).

39. Ibid.

Deadline Requirement[40]

The request for relief under IRC §6015(b) (and under §6015(c), discussed later) must be made no later than **two years** from the date of the first collection activity against the requesting spouse for the joint tax liability.

In addition, although the spouse can submit the request before the commencement of collection activity, they cannot make the request prematurely. A request is **premature** if it is submitted before the IRS sends notice of an audit or underpayment for that tax year.

> **Note.** The definition of **collection activity** is found in Treas. Reg. §1.6015-5(b)(2) and includes a notice of right to a collection due process hearing and the filing of a lawsuit against the requesting spouse by the IRS to collect the tax.

How to Request Relief[41]

A spouse makes a request for relief under §6015(b) by filing Form 8857, *Request for Innocent Spouse Relief.* Alternatively, IRS guidance indicates that the requesting spouse may also submit a written statement, signed under penalties of perjury, that contains the same information as Form 8857.

Nonrequesting Spouse's Procedural Rights[42]

Once a request for relief under §§6015(b) has been received, the IRS must send a notice to the nonrequesting spouse.[43] The notice is sent to the nonrequesting spouse's last known address.

> **Note.** For purposes of this rule, the definition of **last known address** is found in Treas. Reg. §301.6212-2.

The notice must provide the nonrequesting spouse with the opportunity to submit additional information for the IRS to consider in its decision about whether to grant relief to the requesting spouse. However, the nonrequesting spouse is not required to submit any information. In addition, at the request of either spouse, the IRS will share the information submitted by one spouse with the other spouse (unless such communication would jeopardize tax administration).

Under Treas. Reg. §1.6015-6(b), the IRS will consider all relevant information submitted by the nonrequesting spouse in its determination about whether to grant relief to the requesting spouse. This includes information about:

- The legal status of the spouses' marriage,
- The extent of the requesting spouse's knowledge of the erroneous items or underpayment,
- The extent of the requesting spouse's knowledge or participation in the family business or financial affairs (if applicable),
- The requesting spouse's education level,
- The extent to which the requesting spouse benefitted from the erroneous items,
- Any asset transfers between the spouses,
- Any indication of fraud on the part of either spouse,
- Whether it would be inequitable to hold the requesting spouse jointly and severally liable for the outstanding liability, and
- The allocation or ownership of items giving rise to the deficiency.

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40. Treas. Reg. §1.6015-5.
41. Ibid.
42. Treas. Reg. §1.6015-6.
43. Treas. Reg. §1.6015-6(a).

Observation. Because regulations require the IRS to notify the nonrequesting spouse and provide an opportunity to respond, there is **no exception** to such notice in situations involving domestic violence. For further details, including information about what the IRS will not disclose to the nonrequesting spouse, see IRS Pub. 971, *Innocent Spouse Relief*.

Any information submitted by the nonrequesting spouse will be taken into consideration if the nonrequesting spouse also requests relief from joint and several liability.

ALLOCATION RELIEF

A separate option for innocent spouse relief is provided by IRC §6015(c) and Treas. Reg. §1.6015-3. This **allocation relief** provision is different from the general relief provision. It can provide relief from a joint tax return liability arising from items allocable to the nonrequesting spouse.

Note. Treas. Reg. §1.6015-3(a) uses the term **deficiency** to describe the tax liability allocable to the nonrequesting spouse that must exist as a prerequisite to relief.

The **burden of proof** is on the requesting spouse to establish eligibility for relief under this provision.[44] Although this provision may be used to limit liability for unpaid taxes, it cannot be used to obtain a refund.[45]

To qualify for allocation relief, the requesting spouse must be divorced, widowed, or legally separated from the nonrequesting spouse. However, the requesting spouse may qualify if they were not a member of the same household as the nonrequesting spouse at any time during the 12-month period before the date the request is filed. Temporary absences from the household do not qualify as periods away from the household if it is reasonable to assume the requesting spouse will return and the household was maintained in anticipation of that eventual return.[46] Temporary absences may include periods of illness, business travel, military service, education, or incarceration. Even when the spouses maintain separate dwellings, the requesting spouse will not be eligible for relief if circumstances indicate that the time away from a shared household is temporary.[47]

On behalf of a deceased requesting spouse, an executor may:[48]

- Pursue a request for relief that the requesting spouse filed while alive, or
- File a request after the requesting spouse's death (as long as the decedent met the eligibility requirements while alive).

A deceased requesting spouse's marital status is determined at the earlier of the date on which the request was filed or the date of death.[49]

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44. Treas. Reg. §1.6015-3(d)(3).
45. Treas. Reg. §1.6015-3(c)(1).
46. Treas. Reg. §1.6015-3(b)(3)(i).
47. Treas. Reg. §1.6015-3(b)(3)(ii).
48. Rev. Rul. 2003-36, 2003-18 IRB 849.
49. Treas. Reg. §1.6015-3(a).

Requirements

Under the IRC §6015(c) allocation relief provision, the same knowledge requirement that applies to the general relief provision under IRC §6015(b), is applicable.[50] This includes the exception for victims of abuse. Similarly, the same joint ownership and partial knowledge rules apply.

> **Observation.** If the nature of the spouse's knowledge of the understatement disqualifies them from the §6015(b) general relief provision discussed previously, that same knowledge will also prevent them from obtaining relief under the §6015(c) allocation relief provision.[51] However, relief under the §6015(f) equitable relief provision (discussed later) may be possible.

Allocation Rules

For a requesting spouse who obtains allocation relief, the allocation of the joint and several tax liability limits the requesting spouse's liability only to those items attributable to them. However, the nonrequesting spouse who does not make a similar request remains liable for the full amount of tax deficiency for the year.[52]

In addition, if both spouses make such a request, part of the tax liability may not be allocable to one spouse or the other. To the extent that part of the tax liability is not allocable to either spouse, both spouses remain jointly and severally liable for that amount.[53]

When a joint return has a deficiency assessed because of one or more **errors** on the original return (such as omitted income or a disallowed deduction), the amount of that deficiency allocated to the spouses depends on the dollar amount of errors on the return attributable to each spouse. Erroneous income items are allocated to the spouse who performed the services that produced the income or who was the source of the income. Erroneous deduction items related to a business or investment are allocated to the spouse who owned the business or investment. If both spouses owned the business or investment relating to the erroneous income or deduction item, the item is allocated according to the spouses' proportionate ownership interests. The allocation is generally 50% to each spouse in the absence of any clear and convincing evidence that a different allocation is appropriate.[54]

Generally, the deficiency allocable to each spouse is calculated using the following formula.

$$\text{Amount of deficiency allocated to spouse} = \text{Total deficiency} \times \frac{\text{Net amount of errors attributable to spouse}}{\text{Net amount of all errors}}$$

50. Treas. Reg. §1.6015-3(c)(2).

51. See, e.g., *Howerter v. Comm'r*, TC Summ. Op. 2014-15 (Feb. 19, 2014).

52. Treas. Reg. §1.6015-3(d).

53. Ibid.

54. Ibid.

Example 9. Don and Debbie divorced in 2015. Their 2014 MFJ return was examined in 2016. As a result of that examination, Don and Debbie have been assessed a deficiency of $18,000. The deficiency was due to the following errors on the return.

1. Don claimed $15,000 of business expenses (for travel, meals, and entertainment) on his Schedule C, *Profit or Loss from Business,* that were disallowed because it was determined that these were personal expenses.
2. Don received a 2014 Form 1099-INT, *Interest Income,* for $10,000 from a certificate of deposit that is solely in his name. The interest was not reported on the return.
3. Don claimed a $5,000 charitable contribution deduction that was disallowed because he failed to obtain the necessary supporting documentation for the donation.
4. Debbie claimed a $20,000 interest deduction, but it was established during the examination that the interest she paid did not qualify for such a deduction.

The erroneous items attributable to Don and to Debbie are summarized as follows.

Error	Don	Debbie	Total
Business expenses	$15,000		$15,000
Interest	10,000		10,000
Charitable donation	5,000		5,000
Interest deduction		$20,000	20,000
	$30,000	$20,000	$50,000

Debbie requests relief under §6015(c) in 2016. Her request is for relief from liability for the portion of the $18,000 deficiency that resulted from the erroneous items attributable to Don. If Debbie's request for relief is granted, the $18,000 tax liability will be apportioned between the spouses, with Debbie being liable only for her share.

The deficiency allocable to Debbie is based on the amount of errors attributable to her compared with the total amount of all the errors made on the return. This is calculated as follows.

$$\text{Amount of deficiency allocated to Debbie} = \text{Total deficiency} \times \frac{\text{Net amount of errors attributable to Debbie}}{\text{Net amount of all errors}}$$

$$= \$18{,}000 \times \frac{\$20{,}000}{\$50{,}000}$$

$$= \$7{,}200$$

Accordingly, if Debbie's request is granted by the IRS, she will be liable for $7,200 of the $18,000 tax liability, and that is the maximum amount the IRS may collect from her. However, unless Don makes and is granted a similar §6015(c) request, he will remain liable for the full $18,000 deficiency and the IRS may attempt to collect that full amount from him under the joint and several liability rules.

Example 10. Use the same facts as **Example 9,** except the $10,000 of interest income came from a joint certificate of deposit. Because the $10,000 interest income is attributable to a joint asset, that error is shared equally between the spouses. The following table summarizes the errors attributable to Don and to Debbie and the calculation allocating the remaining $15,000 deficiency.

Error	Don	Debbie	Total
Business expenses	$15,000		$15,000
Interest income	5,000	$ 5,000	10,000
Charitable donation	5,000		5,000
Interest deduction		20,000	20,000
	$25,000	$25,000	$50,000

The deficiency allocable to Debbie is based on the amount of errors attributable to her compared with the total amount of all the errors made on the return. This is calculated as follows.

$$\text{Amount of deficiency allocated to Debbie} = \text{Total deficiency} \times \frac{\text{Net amount of errors attributable to Debbie}}{\text{Net amount of all errors}}$$

$$= \$18{,}000 \times \frac{\$25{,}000}{\$50{,}000}$$

$$= \$9{,}000$$

Accordingly, if Debbie's request is granted by the IRS, she will be liable for $9,000 of the $18,000 tax liability, and that is the maximum amount the IRS may collect from her. However, unless Don makes and is granted a similar §6015(c) request, he will remain liable for the full $18,000 deficiency, and the IRS may attempt to collect that full amount from him under the joint and several liability rules.

Example 11. Use the same facts as **Example 10,** except the IRS is able to meet its burden of proof to establish that Debbie had actual knowledge of the interest income. The IRS meets its burden because the interest was deposited into the spouses' joint checking account, and Debbie used some of the funds to purchase stocks in her name. Accordingly, the portion of Debbie's request for relief attributable to this $10,000 interest income is invalidated because of her actual knowledge. However, her relief request may still serve to allocate the remaining deficiency. If $3,000 of the deficiency is attributable to the $10,000 interest income, $15,000 ($18,000 − $3,000) of deficiency may be allocated. The erroneous items attributable to Don and to Debbie are summarized as follows.

Error	Don	Debbie	Total
Business expenses	$15,000		$15,000
Charitable donation	5,000		5,000
Interest deduction		$20,000	20,000
	$20,000	$20,000	$40,000

The deficiency allocable to Debbie is based on the amount of errors attributable to her compared with the total amount of all the errors made on the return. This is calculated as follows.

$$\text{Amount of deficiency allocated to Debbie} = \text{Total deficiency} \times \frac{\text{Net amount of errors attributable to Debbie}}{\text{Net amount of all errors}}$$

$$= \$15{,}000 \times \frac{\$20{,}000}{\$40{,}000}$$

$$= \$7{,}500$$

Debbie remains jointly and severally liable for the $3,000 of deficiency attributable to the interest income because the IRS established her actual knowledge of this erroneous item. However, she will be liable for only $7,500 of the remaining deficiency of $15,000 if the IRS grants her request. Don, however, will remain liable for the entire $18,000 deficiency unless he requests and is granted relief.

Note. In the preceding examples, although Don is jointly and severally liable for the full $18,000 and Debbie's liability will be reduced if her relief request is granted, the maximum aggregate amount the IRS may collect from both spouses is the $18,000 deficiency.

Disqualified Asset Transfers

Any liability that the requesting spouse has for a deficiency under the rules for allocation relief will be **increased by the fair market value (FMV) of any disqualified asset that the nonrequesting spouse transferred to the requesting spouse.** A **disqualified asset** is generally any property that the nonrequesting spouse transferred to the requesting spouse for the principal purpose of avoiding tax liability or the payment of tax. There is a **presumption** that any asset transferred from the nonrequesting to the requesting spouse is a disqualified asset if that asset is transferred:[55]

- During the 12-month period before the mailing date of an IRS 30-day letter or notice of deficiency to the spouses, or
- Any time after the mailing date of the first IRS letter indicating there is a deficiency.

However, the presumption does not apply to transfers that are made pursuant to a divorce decree, separation order, or other such written instrument. Yet even if the presumption does not apply, the IRS may still establish that the purpose of the asset transfer was tax avoidance. This will disqualify the asset, and the asset's FMV will be added to the amount of deficiency the requesting spouse would otherwise have under the allocation relief provision.

Note. The requesting spouse may rebut the disqualified-asset presumption by establishing that there was a principal purpose other than tax avoidance for transferring the asset.

For further details regarding requests for relief under §6015(c), including disqualified asset transfers between spouses for tax avoidance purposes, see Treas. Reg. §1.6015-3. This regulation also includes several helpful examples.

55. Treas. Reg. §1.6015-3(c).

Example 12. Use the same facts as **Example 9,** except Don transferred a lump sum of $15,000 to Debbie in April 2015. They were divorced later that year. After examining their return, the IRS mailed a notice of deficiency on February 28, 2016. Because there was a $15,000 asset transfer from the nonrequesting spouse to the requesting spouse less than 12 months before the notice of deficiency was mailed, there is a presumption that the $15,000 was transferred for tax avoidance purposes and is therefore a disqualified asset.

Don sends the IRS a letter indicating that the money was given to Debbie for a purpose other than tax avoidance but does not provide the IRS with any documentation. Accordingly, Debbie is liable for the $7,200 liability allocated to her (as calculated in **Example 9)** but is also liable for an additional $15,000 (the FMV of the disqualified asset). This would make Debbie's liability $22,200.

Debbie cannot be liable for more than the total amount of the deficiency. Therefore, she will remain jointly and severally liable for the full $18,000 deficiency. The maximum that the IRS can collect from her is $18,000.

EQUITABLE RELIEF

Equitable relief, provided by IRC §6015(f), is the third option available to a spouse seeking relief from joint and several liability for a deficiency on an MFJ return. However, this equitable relief option is available only to a spouse that does not qualify for either §6015(b) general relief or §6015(c) allocation relief.[56]

Under this provision, the IRS can grant relief if after considering all relevant facts and circumstances it would be inequitable to hold the requesting spouse jointly and severally liable for either an unpaid tax or a tax deficiency.[57] In this equitable relief provision, the IRS recognized congressional intent to provide relief when the requesting spouse did not know the other spouse used funds intended to pay tax for other purposes.[58]

In equitable relief requests involving both understatement and underpayment, if the requesting spouse can establish that they made separate payments from their own funds, they may obtain a refund of such payments. However, no refund is available for payments made by the nonrequesting spouse, made jointly with the nonrequesting spouse, or made with the joint return.[59]

How to Request Relief

As with the general relief and allocation relief provisions, a request for equitable relief is made using Form 8857 (or another similar signed statement).

Equitable Relief Guidance

The primary guidance regarding innocent spouse equitable relief is provided by Rev. Proc. 2013-34.[60] This revenue procedure provides equitable relief guidance in the following areas.

- Eligibility for relief
- When streamlined relief determination will be used by the IRS
- Factors used in determining whether a requesting spouse should be granted relief

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56. Treas. Reg. §1.6015-1(a).
57. IRC §6015(f)(1).
58. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 2.04).
59. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 4.04).
60. Rev. Proc. 2013-34, 2013-43 IRB 397.

Eligibility

To be eligible for equitable relief, the **joint return requirement** (described earlier) must be met for the year relief is requested. As mentioned earlier, the requesting spouse cannot be eligible for relief under the general or allocation relief provisions. In addition, the requesting spouse must meet **five other** eligibility requirements for equitable relief as follows.

1. The request for relief must be timely made.
2. No fraudulent transfers must be made between spouses.
3. No disqualified asset transfers must exist between spouses.
4. No fraudulent returns were filed.
5. Items from which relief is being sought must be attributable to the nonrequesting spouse.

Timely Request. Under IRC §6502, the IRS generally has 10 years from the date of tax assessment to collect the tax assessed. The final day of this 10-year period is referred to as the **collection statute expiration date** (CSED). A request for relief from liability for an unpaid tax amount generally must be made before the CSED in order to be considered timely.

Moreover, IRC §6511 provides a deadline for a refund claim. A refund claim must be made before the latter of three years from the time the return was filed or two years from the time the tax was paid.

No Fraudulent Transfers. The requesting spouse must establish that no asset transfers were made between the spouses that are part of a fraudulent scheme.

> **Observation.** Rev. Proc. 2013-34 provides no information about how a requesting spouse may establish the absence of fraud in connection with an asset transfer.[61] Presumably, this issue would arise only if the reviewing IRS employee had reason to believe a fraudulent transfer may have occurred and made additional inquiries of the requesting spouse. Establishing a legitimate purpose for the asset transfer in the absence of any fraud would provide a sufficient justification by the requesting spouse. Form 8857 specifically asks about asset transfers between spouses.

No Disqualified Asset Transfers. The requesting spouse must establish that no disqualified asset transfers were made from the nonrequesting spouse to the requesting spouse.

> **Observation.** Form 8857 asks the requesting spouse to disclose the nature of any assets transferred, along with their value and the dates transferred. It also asks about any debts secured by those assets. The requesting spouse must also explain why they received the assets. This provides the IRS with some initial information about asset transfers that may involve disqualified assets.

> **Note.** Under the equitable relief provision, the term **disqualified asset** has the same meaning as when used in the allocation relief provision. If the requesting spouse has received a disqualifying asset, they may still be eligible for equitable relief. However, the extent of relief may be limited to the amount by which the tax liability exceeds the FMV of the disqualified asset.[62]

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61. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 4.01(5)).
62. Ibid.

No Fraudulent Return. The requesting spouse must establish that they did not knowingly participate in filing a fraudulent joint return.

> **Observation.** Form 8897 requires the requesting spouse to provide information about their role in preparing tax returns and their involvement in the household finances during the years for which relief is requested.

Nonrequesting Spouse Tax Items. The requesting spouse must be seeking relief from tax liability that is attributable to the nonrequesting spouse. If part of the tax liability is attributable to the requesting spouse, the IRS may grant relief for that part of the liability attributable to the nonrequesting spouse. However, the IRS considers granting relief even if the liability is entirely or partially attributable to the requesting spouse under certain conditions.[63]

- The attribution to the requesting spouse is due solely to the application of state community property laws.
- The requesting spouse only nominally owns the asset underlying the tax liability (such as when the nonrequesting spouse forges the requesting spouse's signature on an ownership document).
- The nonrequesting spouse misappropriated funds intended to pay some or all of the tax liability, and the requesting spouse had no knowledge of the misappropriation.
- The requesting spouse was unable to challenge the nonrequesting spouse about items shown on the return or question the balance due because of abuse suffered by the requesting spouse prior to the time the return was filed.
- The requesting spouse establishes that the reason for the errors on the return is fraud committed by the nonrequesting spouse.

> **Note.** For further details regarding these exceptions, including possible limitations, see Rev. Proc. 2013-34, section 4.01(7).

Streamlined Determination[64]

When the requesting spouse meets all the factors necessary to qualify for equitable relief and meets the following three additional eligibility requirements, the IRS makes a streamlined decision regarding equitable relief. Eligibility for streamlined relief exists if the requesting spouse:

1. Is no longer married to the nonrequesting spouse,
2. Will suffer economic hardship if relief is not granted, and
3. Did not know or have reason to know about the understatement or deficiency on the joint income tax return.

> **Note.** The requesting spouse **must meet all three** of the eligibility requirements **for streamlined relief.** For further details on these three factors, see Rev. Proc. 2013-34, section 4.02.

63. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 4.01(7)).
64. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 4.02).

Equitable Relief Factors

When the requesting spouse does not meet the three tests necessary for a streamlined determination, the IRS considers the request by looking at the following seven factors.[65]

1. **Marital status**
2. **Economic hardship** that may result from the payment of the tax
3. **Knowledge or reason to know** of the understatement or underpayment of tax
4. **Obligation to pay** the tax liability based on language in a divorce decree or other document
5. **Significant benefit** obtained from the nonpayment or underpayment of the tax liability
6. **Tax compliance** in years subsequent to the year for which relief is requested
7. **Health** of the requesting spouse

The determination of whether equitable relief should be granted is made by taking into account all the requesting spouse's relevant facts and circumstances. Although Rev. Proc. 2013-34 provides a list of the preceding factors, it specifically indicates that this list is intended only as a guide and is not exclusive. In addition, no single factor or majority of factors is necessarily determinative, and the level of importance of each factor varies with the facts and circumstances of each case.

Marital Status. If the requesting spouse is **no longer married** to the nonrequesting spouse (as of the date the IRS makes its determination), this factor weighs in favor of relief. Under this rule, the requesting spouse is considered no longer married if the requesting spouse is:

- Divorced or legally separated from the nonrequesting spouse,
- A widow(er) of the nonrequesting spouse (and is not an heir of the nonrequesting spouse's estate that has assets sufficient to pay the tax liability from which relief is being sought), or
- Not a member of the same household as the nonrequesting spouse for the 12-month period ending on the date that the IRS makes its decision on the relief request. (A requesting spouse is still considered a member of the nonrequesting spouse's household during times of temporary absence when the requesting spouse is expected to return to the household. The spouses are considered to be members of the same household as long as they maintain the same residence.)

If the requesting spouse is still married to the nonrequesting spouse, this factor is neutral.

Economic Hardship. Economic hardship exists if the requesting spouse's payment of some or all of the tax liability would mean that the requesting spouse would be unable to pay basic living expenses. The requesting spouse's current income, expenses, and assets are taken into consideration. In making a determination of economic hardship, the IRS compares the requesting spouse's income with the federal poverty guidelines (frequently referred to as the **federal poverty level, or FPL**) for the requesting spouse's family size.

This factor weighs in favor of granting relief if either of the following applies.

- The requesting spouse's income is below 250% of the FPL, and they do not have assets from which payments toward the tax liability may be made and still meet their reasonable basic living expenses.
- The requesting spouse's income exceeds the 250% FPL threshold, but their monthly income exceeds expenses by $300 or less (unless there are assets from which payments toward the tax liability can be made while still adequately meeting reasonable basic monthly living expenses).

> **Note.** FPL amounts are updated annually by the U.S. Department of Health and Human Services. For current FPL amounts, go to **uofi.tax/16b1x1** [www.healthcare.gov/glossary/federal-poverty-level-FPL].

If the request is being made on behalf of a deceased spouse, this factor is neutral.

65. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 4.03).

Knowledge or Reason to Know. In a request that involves an **understatement** of tax liability, this requirement involves whether the requesting spouse knew (or had reason to know) about the item that caused the understatement at the time the joint return (or amended return) was filed. If the requesting spouse did not have such knowledge, this will weigh in favor of relief.

The existence of such knowledge will weigh against relief. Even if actual knowledge exists, however, this factor will not be weighed more heavily than other factors considered in the overall determination of whether to grant equitable relief to the requesting spouse.

In addition, even if the requesting spouse had actual knowledge, this factor may weigh in favor of relief if abuse or financial control by the nonrequesting spouse precluded the requesting spouse from challenging the treatment of items on the joint return because of fear of retaliation.

In a request involving **underpayment,** this factor involves whether the requesting spouse knew or had reason to know that the nonrequesting spouse would not (or did not have the ability) to pay the tax. The requesting spouse's knowledge at the time the return was filed (or the time the requesting spouse reasonably believed it was filed) is considered in weighing this factor.

Regarding both understatement and underpayment, whether the requesting spouse had reason to know about the tax liability or whether the nonrequesting spouse could or would pay that liability depends on the facts and circumstances of the case. The facts considered include the following information about the requesting spouse.[66]

- Level of education
- Degree of involvement in the activity that caused the tax liability
- Degree of involvement in business or household financial matters
- Deceitful or evasive behavior
- Business or financial expertise

Other information about the following are also considered.

- Spending on unusual or lavish items outside the scope of the spouses' historical spending patterns
- Any deceitful or evasive behavior of the nonrequesting spouse

These factors weigh in favor of relief if the requesting spouse reasonably expected the nonrequesting spouse to pay the tax liability shown on the return at the time the return was filed (or within a reasonable period of time thereafter). Such reasonable expectation is **presumed** if the spouses requested an **installment agreement** that:

- Was filed by the later of either 90 days after the tax payment due date or 90 days after the filing of the return, and
- The request provided a detailed plan for the payment of the tax and any applicable interest and penalties within a reasonable time.

If the facts and circumstances indicate that it was not reasonable for the requesting spouse to believe that the nonrequesting spouse would pay (or would have the ability to pay) the unpaid tax, this factor will weigh against granting equitable relief. The requesting spouse's knowledge of the nonrequesting spouse's financial difficulties or prior bankruptcies may lead to the conclusion that such belief is not reasonable.

66. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 4.03(2)(c)(iii)).

In addition, if abuse or financial control by the nonrequesting spouse precluded the requesting spouse from questioning the payment of taxes reported, this factor may weigh in favor of relief. This is true even if the requesting spouse knew the nonrequesting spouse would not pay the tax (or lacked the ability to do so).

> **Note.** Abuse may be taken into account as part of the facts and circumstances surrounding the request for relief.

Obligation to Pay. Obligation to pay involves a determination of whether either the requesting or nonrequesting spouse has a legal obligation to pay the tax liability under the terms of a divorce decree or other legally binding agreement. This factor weighs in favor of relief for the requesting spouse if the nonrequesting spouse has the sole payment obligation. This factor weighs against granting relief if the requesting spouse has the sole payment obligation.

However, if the nonrequesting spouse has the sole payment obligation and the requesting spouse knew (or had reason to know) at the time the legally binding agreement was made that payment by the nonrequesting spouse would not be made, this factor will be neutral. This factor is also neutral if:

- Both spouses have a legal obligation to pay the tax,
- An existing divorce decree or other agreement is silent on the issue of tax payment liability, or
- The spouses are not separated or divorced.

Significant Benefit. Whether the requesting spouse received a **significant benefit** from the unpaid tax liability or understatement is also a factor considered in determining whether relief should be granted. A significant benefit exists if the requesting spouse receives a benefit in excess of normal support, such as owning luxury items or taking expensive vacations. If the requesting spouse receives such a benefit, this factor will weigh against granting relief.

However, if the requesting spouse was subjected to abuse or if the nonrequesting spouse controlled household financial decisions (including lavish spending decisions), then this factor is neutral. Further, this factor will weigh in favor of relief if the nonrequesting spouse receives most or all of the benefit from the unpaid tax liability or understatement. If the amount of tax liability is small, such that neither spouse would receive any significant benefit from its nonpayment, this factor is neutral.

Tax Compliance. Another factor considered in determining whether to grant relief is whether the requesting spouse has made a good-faith effort to comply with income tax laws for the years subsequent to the year for which relief was requested. Noncompliance will weigh against granting relief, but this factor is neutral if the requesting spouse made a good-faith effort to comply with tax laws but was unable to fully do so. For example, if the requesting spouse has filed timely tax returns for the years after the year for which relief is requested but fails to pay any tax owed because of postdivorce financial difficulty, this factor will be neutral.

Regardless of whether the spouses are legally separated or living apart, if the requesting spouse remains married to the nonrequesting spouse and continues to file compliant MFJ returns, this factor will be considered neutral. However, this factor weighs against granting relief if the MFJ returns are noncompliant.

Health. The health of the requesting spouse weighs in favor of granting relief if they were in poor mental or physical health either at the time relief is requested or at the time the return related to the relief request was filed. The IRS considers the nature, extent, and duration of the illness along with any ongoing economic impact it caused. This factor is neutral if the requesting spouse was not in poor health.

Abuse by a Nonrequesting Spouse

If a requesting spouse establishes that they were a victim of spousal abuse, IRS guidance[67] indicates that the abuse may be considered in the determination of whether to grant equitable relief. Depending on the facts and circumstances, the existence of abuse may cause any of the previously mentioned factors to weigh in favor of relief (even if a factor would otherwise weigh against granting relief). All facts and circumstances are considered to determine whether a requesting spouse was abused.

IRS guidance acknowledges that **abuse** may be physical, psychological, sexual, or emotional. It may include efforts to intimidate, humiliate, or isolate the requesting spouse or to jeopardize the requesting spouse's ability to reason independently and do what is necessary to comply with tax laws. Abuse of a child or other family member of the requesting spouse living in the household may constitute abuse of the requesting spouse.

Limitation on Equitable Relief Refunds

Rules limit a requesting spouse's ability to obtain a refund in cases of understatement or underpayment when they request equitable relief. The requesting spouse may obtain a refund for separate payments that they establish were made exclusively from their own funds.

No refund is available from payments made with an MFJ return or joint payments made with the nonrequesting spouse. However, if a portion of a joint overpayment from another tax year is applied to the joint tax liability from which relief is requested, the requesting spouse may be eligible for a refund of their portion to the extent they establish that the overpayment came from their own funds.

In addition, the requesting spouse cannot obtain a refund for payments made exclusively by the nonrequesting spouse. Moreover, the limitations rules of IRC §6511 apply, including the 3-year limitations period for refunds.

INJURED SPOUSE RELIEF

Injured spouse relief is separate and distinct from the relief provided under the innocent spouse rules. Injured spouse relief generally provides a spouse with the ability to recover their share of an anticipated **refund** from an MFJ return that was first used to offset certain debts or obligations of the other spouse.

A tax overpayment is typically refunded to the taxpayer. However, the IRS has statutory authority to instead apply a tax overpayment to certain other debts and obligations of the taxpayer.[68] The debts against which a tax overpayment can be applied are as follows.[69]

- Any unpaid federal taxes from prior years
- Past-due child or parental support assigned to a state
- Debts owed to a federal agency
- Past-due child support or parental support not assigned to a state
- Legally enforceable unpaid state income taxes[70]

> **Note.** For further details on the criteria that particular debts must meet to be subject to these rules, see IRC §6402 and the underlying regulations.

67. Rev. Proc. 2013-34, 2013-43 IRB 397 (Section 4.03(2)(c)(iv)).
68. IRC §6402; Treas. Reg. §301.6402-3(a)(6).
69. Ibid.
70. Treas. Reg. §285.3(d).

When a tax overpayment is shown on a joint return, the IRS generally applies the entire tax overpayment against any of the debts in the preceding list.[71] This is referred to as an **offset.** Accordingly, the entire overpayment can be applied against the debts of one spouse, using an overpayment amount that the other spouse who had no such debts to satisfy has an interest. The spouse who would have obtained a refund but for the other spouse's debts is the **injured spouse.** The injured spouse can apply to obtain the refund to which they were entitled.

Injured spouse relief may be useful for a divorced or divorcing spouse whose refund from a previous joint return was applied against the former spouse's debts. However, divorce or separation is not a prerequisite to injured spouse relief. Even a married spouse may use the injured spouse provision.

> **Note.** Generally, the taxpayer receives a notice indicating that an offset has occurred.[72] However, the U.S. Department of the Treasury is not required to issue a preliminary notice to alert a taxpayer that an offset will occur.[73]

PRIORITY RULES

When a taxpayer has two or more of the types of debts subject to offset, a tax overpayment is applied to those debts in the order in which they are shown in the list shown earlier.[74] If there is more than one debt of the same type, the overpayment is applied against the debts in the order in which they accrued.[75]

After all of these debts have been satisfied, any excess overpayment is refunded to the taxpayer.[76] The taxpayer can also elect to have this refundable amount credited as estimated taxes.[77]

APPLYING FOR RELIEF

The apportioned share of an overpayment may be refunded if an injured spouse applies for relief using Form 8379, *Injured Spouse Allocation.* The injured spouse can file this form:[78]

- With a joint tax return before an offset has occurred,
- With an amended return if that amendment results in a refund, or
- On its own, after an offset has occurred.

If Form 8379 is sent with a tax return, "Injured Spouse" should be conspicuously written on the top-left corner of page 1 of the return. The form should be attached to the return in accordance with the sequencing number (found in the upper-right corner of the form). The IRS will process the injured spouse allocation request before applying any overpayment shown on the return to an existing debt.[79]

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71. IRM 25.18.5.1 (2011).
72. *Topic 203 – Refund Offsets for Unpaid Child Support, Certain Federal and State Debts, and Unemployment Compensation Debts*. Dec. 30, 2015. IRS. [www.irs.gov/taxtopics/tc203.html] Accessed on Feb. 3, 2016.
73. IRM 25.18.5.1 (2011), referring to *Fulgoni v. U.S.*, 23 Cl. Ct. 119 (1991).
74. Treas. Reg. §301.6402-6(g)(1).
75. Treas. Reg. §301.6402-6(g)(2).
76. Treas. Reg. §301.6402-6(g)(3).
77. Ibid.
78. Instructions for Form 8379.
79. *Seven Facts about Injured Spouse Relief*. Nov. 4, 2013. IRS. [www.irs.gov/uac/Seven-Facts-about-Injured-Spouse-Relief] Accessed on Feb. 3, 2016.

For a separately filed Form 8379, all Forms W-2, *Wage and Tax Statement;* W-2G, *Certain Gambling Winnings;* and 1099-MISC, *Miscellaneous Income,* that show federal tax withholding should be attached to expedite processing. A copy of the previously filed joint return should **not** be attached because this may delay processing.[80]

> **Note.** The IRS calculates the injured spouse's share of the overpayment. For an injured spouse in a community property state, the IRS divides the joint overpayment in accordance with state law.[81]

> **Note.** To determine whether a taxpayer may qualify for injured spouse relief, a simple online questionnaire is available at **uofi.tax/16b1x2** [www.irs.gov/Individuals/Tax-Trails---Can-I-File-an-Injured-Spouse-Claim%3F-10].

APPORTIONMENT OF THE TAX OVERPAYMENT

The IRS has established a method for apportioning the tax overpayment amount between the spouses. This process is used to determine the amount of overpayment refundable to the injured spouse. The apportionment is based on the spouses' respective contributions to the tax payments for the year, not on their respective incomes that gave rise to the tax liability.

The first step in apportioning the tax overpayment is to determine each spouse's portion of the joint tax liability. Under the injured spouse rules, this is calculated using the following **separate tax formula.**

$$\text{Spouse's portion of joint tax liability} = \frac{\text{Spouse's separate tax liability}}{\text{Both spouses' separate tax liabilities}} \times \text{Joint tax liability}$$

Next, each spouse's contribution to the payment of the joint tax liability must be determined. Each spouse's tax withholding on wages and other income counts as a contribution toward payment of the joint tax liability for that spouse.

If the spouses make estimated tax payments and payments with the joint return, the contribution from each spouse is a question of fact and depends on the source of funds from which they made the payments. However, in the absence of clear and convincing evidence about which spouse made such payments, the IRS uses the following **estimated tax formula** to apportion the estimated payments between the spouses.[82]

$$\text{Spouse's contribution} = \frac{\text{Spouse's separate tax liability}}{\text{Both spouses' separate tax liabilities}} \times \text{Estimated tax payments}$$

> **Note**. For additional guidance on how to allocate estimated tax payments between spouses, see Rev. Rul. 80-7.

Lastly, each spouse's share of the overpayment must be determined. This is calculated for each spouse by taking the amount contributed to the joint tax liability for each spouse (calculated using the estimated tax formula) and subtracting from it each spouse's respective portion of the joint tax liability (calculated using the separate tax formula). This is reflected by the following formula.

$$\text{Spouse's refund amount} = \text{Spouse's contribution} - \text{Spouse's share of joint tax liability}$$

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80. *Topic 203 – Refund Offsets for Unpaid Child Support, Certain Federal and State Debts, and Unemployment Compensation Debts.* Dec. 30, 2015. IRS. [www.irs.gov/taxtopics/tc203.html] Accessed on Feb. 3, 2016.

81. Ibid.

82. Rev. Rul. 80-7, 1980-1 CB 296.

Example 13. Mike and Laura finalized their divorce in early 2016. Their 2015 tax return was the last return they filed jointly. Mike has $15,000 of unpaid federal taxes from a prior year. The relevant figures for the couple's 2015 MFJ return, along with applicable MFS amounts for each spouse, are as follows.

	Mike MFS	Laura MFS	MFJ Return as Filed
Wages	$40,000	$50,000	$90,000
Federal tax withheld on wages	6,000	9,000	15,000
Standard deduction	6,300	6,300	12,600
Exemptions	4,000	4,000	8,000
Taxable income	29,700	39,700	69,400
Tax liability	3,998	5,725	9,491

The 2015 joint tax return showed a total tax liability of $9,491 and an overpayment amount of $5,509. The IRS applied the entire $5,509 overpayment to Mike's unpaid tax liability. Mike and Laura would have received a refund of this overpayment had it not been for Mike's unpaid taxes. Part of the $5,509 refund would have been attributable to Laura.

After the divorce in 2016, Laura applied for injured spouse relief to obtain a refund of the 2015 overpayment attributable to her. To determine how much of the $5,509 overpayment is attributable to each spouse under the injured spouse rules, the following calculations were made.

Each spouse's portion of the joint tax liability (JTL) was calculated using the separate tax formula.

$$\text{Mike's portion of joint tax liability} = \frac{\text{Mike's MFS tax liability}}{\text{Both spouses' MFS tax liability}} \times \text{Joint tax liability}$$

$$= \frac{\$3{,}998}{\$3{,}998 + \$5{,}725} \times \$9{,}491$$

$$= 0.411 \times \$9{,}491$$

$$= \$3{,}901$$

$$\text{Laura's portion of joint tax liability} = \frac{\text{Laura's MFS tax liability}}{\text{Both spouses' MFS tax liability}} \times \text{Joint tax liability}$$

$$= \frac{\$5{,}725}{\$3{,}998 + \$5{,}725} \times \$9{,}491$$

$$= 0.589 \times \$9{,}491$$

$$= \$5{,}590$$

Next, each spouse's contribution to the payment of the joint tax liability must be determined. In this case, Mike and Laura have each contributed the federal tax that was withheld from their wages. Therefore, Mike's contribution toward payment of the joint tax liability was $6,000 and Laura's was $9,000.

Finally, each spouse's share of the overpayment was calculated by taking each spouse's contribution toward payment of the joint tax liability minus each spouse's respective share of the joint tax liability. These calculations follow.

	Contribution to JTL	Portion of JTL	Apportioned Amount of Overpayment
Mike	$ 6,000	$3,901	$2,099
Laura	9,000	5,590	3,410
Total	$15,000	$9,491	$5,509

Because Laura's apportioned amount of the overpayment is $3,410, this is the amount of refund she may obtain if the IRS grants injured spouse relief. Mike's $2,099 overpayment will be applied against his tax debt from a prior year.

Note. The outcome may be different for an injured spouse in a community property state. See the following revenue rulings for guidance.

- Rev. Rul. 2004-71, 2004-2 CB 74 (Arizona and Wisconsin)
- Rev. Rul. 2004-72, 2004-2 CB 77 (California, Idaho, and Louisiana)
- Rev. Rul. 2004-73, 2004-2 CB 80 (Nevada, New Mexico, and Washington)
- Rev. Rul. 2004-74, 2004-2 CB 84 (Texas)

LIFE INSURANCE COMPANY DEMUTUALIZATION UPDATE

BACKGROUND INFORMATION

Mutual Insurance Companies

Policyholders are the owners of mutual life insurance companies, and they have both ownership rights and policyholder rights. **Ownership rights** include voting and sharing in distributions made by the mutual life insurance company. **Policyholder rights** are the contractual insurance rights. The purpose of mutual life insurance companies is to provide insurance to policyholders at the lowest possible cost.

Demutualization

Many former mutual life insurance companies have converted to publicly traded stock corporations. This process is called **demutualization.** The principal reason for demutualization is to raise additional capital through an initial public offering (IPO). **When a mutual life insurance company demutualizes, it issues stock to the policyholders to compensate them for the loss of their mutual ownership rights.**

DEMUTUALIZATION TAX ISSUE

Demutualization has created a contentious tax issue: **When a former mutual life insurance policyholder sells the stock received in the publicly traded life insurance company, what is the allowable cost basis of that stock?**

This tax issue was decided by two circuits of the U.S. Court of Appeals. The discussion and analysis of these two differing appeals court decisions follows.

Pro-Taxpayer Decision

Fisher, et al. v. U.S.[83] originated in the U.S. Court of Federal Claims and ended in 2009 when the U.S. Court of Appeals for the Federal Circuit upheld the pro-taxpayer decision. The federal circuit issued its decision without a published opinion. The federal claims court held that Mr. Fisher's **cost basis** in his Sun Life insurance policies that were converted to Sun Life common stock upon **demutualization was determined by the total amount of premiums he paid.** Because those premiums exceeded the $31,759 sale price of his Sun Life common stock, **Mr. Fisher realized no capital gain on the sale.**

Observations Regarding the *Fisher* Decision

1. A taxpayer's basis in the stock received and sold due to demutualization cannot exceed the amount of premiums paid. This conclusion is obvious from an analysis of the federal claims court decision.
2. Taxpayers may not have kept records of their premium payments. To obtain the total premium amount, it may be necessary to contact the insurance company.
3. **The *Fisher* rationale represents the best-case scenario for taxpayers.** In many cases, the total policy premiums paid by the taxpayer will exceed the sales price of the common stock received due to demutualization. If so, there will be no realized capital gain on the sale of such stock.

> **Note.** For a thorough analysis of the *Fisher* decision, see pages 571–572 of the 2008 *University of Illinois Federal Tax Workbook,* Chapter 15: Rulings and Cases. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Pro-IRS Decision

The *Dorrance*[84] case has taken several unexpected twists and turns. The latest occurred in December 2015 with the **surprising reversal decision** handed down by the U.S. Court of Appeals for the 9th Circuit.

Bennett Dorrance is an heir to the Campbell Soup Company fortune. In 1996, Mr. and Mrs. Dorrance purchased numerous life insurance contracts from five mutual insurers as part of their estate tax planning. All five insurers later demutualized and converted to stock companies. In 2000 and 2001, the Dorrances received stock in the insurance companies as compensation for their loss of mutual rights.

In 2003, Mr. and Mrs. Dorrance sold the stock received from the five demutualizations. Consistent with the IRS zero cost basis position, they treated the entire sales price of $2.249 million as a long-term capital gain on their joint 2003 tax return. **In 2007, they filed an amended 2003 tax return requesting a refund, arguing that they did have a basis in the stock they sold.**

The refund request was decided by the Arizona District Court in 2013.[85] The court determined that the Dorrances had a cost basis in the stock they sold in 2003. Their basis was equal to:

1. **100%** of the IPO value of the **fixed** shares of common stock received (**$3,164**), plus
2. **60%** of the IPO value of the **variable** shares of common stock received (**$1.075 million**).

Therefore, the total basis of the stock sold was calculated by the court as $1.078 million. The Dorrances' corrected long-term capital gain was $1.171 million ($2.249 million sales price − $1.078 million cost basis). The result was that the taxpayers were entitled to a refund of 2003 taxes of $161,719 ($1.078 million cost basis × 15% capital gains tax rate).

> **Note.** For a thorough analysis of this Arizona District Court decision, see pages B60–B63 of the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Individual Taxpayer Issues. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

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83. *Fisher, et al. v. U.S.*, 82 Fed. Cl. 780 (2008), *aff'd* 333 Fed. Appx. 572 (Fed. Cir. 2009).
84. *Bennett and Jacquelynn Dorrance v. U.S.,* U.S. Court of Appeals, 9th Cir.; Nos. 13-16548, 13-16635 (Dec. 9, 2015).
85. *Dorrance v. U.S.*, No. 2:09-cv-01284 (D. Ariz. 2013).

Mr. and Mrs. Dorrance were likely thrilled with this outcome until the 9th Circuit Court announced its reversal of the prior District Court's pro-taxpayer decision. **The 9th Circuit Court held that the Dorrances had a zero cost basis in the stock they sold in 2003 and thus were not entitled to a refund.**

The 9th Circuit Court's decision was split. One judge who dissented from the majority decision argued that the Arizona District Court's method of calculating the $1.078 million basis in the stock sold was proper. A portion of that dissent follows.

> *For thousands of years, philosophers, theologians, and now physicists, have debated whether the earth was created ex nihilo, i.e., out of nothing. Whatever the answer to that question, there is little doubt that my colleagues in the majority have performed a notable miracle of their own in this case, by creating nothing out of something, i.e., nihil ex aliquo.*

Note. The balance of the dissent is omitted. It explains why the judge perceived that the method used by the Arizona District Court to calculate a significant cost basis in the stock received from demutualization is accurate. However, it cannot be used to satisfy the "reasonable basis" standard explained in the instructions for Form 8275, *Disclosure Statement.*

The 9th Circuit Court's reversal opinion stressed that stock received from a demutualization "was a direct exchange for the lost [mutual] membership rights. Put another way, the basis in the new stock was the same as the basis in what was being exchanged — the [mutual] membership rights."[86]

In its conclusion, the 9th Circuit Court stated:

> ***"Because the Dorrances offer nothing to show payment for their stake in the [mutual] membership rights, as opposed to premium payments for the underlying insurance coverage, the IRS properly rejected their refund claim.*** *The District Court erred when it held that there was a calculable cost basis in the Dorrances' [mutual] membership rights.*[87]

Note. In an unpublished memorandum decision of the 9th Circuit in 2016, the court reached the same result as in the *Dorrance* case. The *Reuben*[88] case also held that stock received pursuant to an insurance company demutualization does not have any income tax basis in the shareholder's hands. The taxpayers (husband and wife) created an irrevocable trust in 1989 and the trust bought an insurance policy from a mutual life insurance company. The trust paid over $1.7 million in premiums over the next 10 years until the time that the company demutualized. The trust received 40,300 shares and later distributed 5,001 of the shares to the taxpayers in 2004, who sold 4,000 of them in 2005 for $160,000. On the taxpayers' 2005 return, the stock sale was reported, with the shares having a zero basis. However, the taxpayers filed an amended return in 2008 for the 2005 tax year. They claimed an income tax basis in the shares consistent with the U.S. Court of Federal Claims decision in *Fisher v. U.S.,*[89] and requested a refund. The IRS rejected the refund request and the taxpayers sued for a refund in federal District Court. The District Court upheld the IRS position and the Appellate Court affirmed. The trial court determined that the open-transaction doctrine used by the *Fisher* court did not apply to stock received upon demutualization.

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86. *Bennett and Jacquelynn Dorrance v. U.S.*, U.S. Court of Appeals, 9th Cir.; Nos. 13-16548, 16635 (Dec. 9, 2015).

87. Ibid.

88. *Reuben v. U.S.,* 628 Fed. Appx. (9th Cir. Jan. 5, 2016).

89. *Fisher, et al. v. U.S.*, 82 Fed. Cl. 780 (2008), *aff'd* 333 Fed. Appx. 572 (Fed. Cir. 2009).

Sale of Stock Received from Demutualizations

Taxpayers must decide which U.S. Court of Appeals decision they will rely on when preparing original or amended returns. From a comparison standpoint, the Federal Circuit Court affirmed *Fisher* without a published opinion, while the 9th Circuit Court of Appeals' published opinion in *Dorrance* was a well-written explanation.

Both Court of Appeals decisions take an all-or-nothing approach. In *Fisher*, the federal circuit decision enabled taxpayers to claim the **maximum cost basis** in the stock acquired from demutualization. In *Dorrance,* the 9th Circuit Court provided taxpayers with a **zero cost basis** for the stock.

This contentious tax issue is likely to be decided by the Supreme Court. Meanwhile, tax preparers are faced with a dilemma: How do they resolve this issue when reporting clients' sales of stock received from a life insurance company's demutualization? The options are discussed next.

Option 1. An aggressive approach is to rely on the *Fisher* decision by the Federal Circuit Court. That would necessitate a possible time-consuming chore to ascertain the total premiums paid to the former mutual life insurance company. Once that information is known, the basis in the stock can be calculated. In many cases, that basis will exceed the sales price of the stock, resulting in no realized capital gain.

Relying on the *Fisher* decision is in direct opposition to the IRS's stated zero cost basis position. In addition, relying on *Fisher* also ignores the tax guidance furnished by the majority of insurance companies to policyholders who receive stock from demutualization. Most insurers recommend in their guidance that the policyholders follow the IRS zero cost position.

Caution. If the *Fisher* rationale is used to compute basis, Form 8275 should be attached to avoid any potential taxpayer and tax return preparer penalties.

Option 2. The safer and less confrontational approach is to accept the IRS zero cost position. If this is done, the practitioner should consider filing a **protective claim** using Form 1040X, *Amended U.S. Individual Income Tax Return.* The protective claim could benefit the taxpayer if the Supreme Court decides the cost basis issue in a more taxpayer-friendly manner than using the IRS zero cost basis position.

When filing Form 1040X, the taxpayer is required to explain the reasons they are filing the amended return. The taxpayer could use the following explanation, depending on the amount of premiums they paid to the former mutual life insurance company. This language assumes that the total premiums paid exceeded the sales price of the stock acquired from demutualization.

The taxpayer is relying on the federal circuit's decision in the *Fisher* case *(Fisher, et al. v. U.S.*, 82 Fed. Cl. 780 (2008), *aff'd*, 333 Fed. Appx. 572 (Fed. Cir. 2009)) to compute the cost basis of the **[insert #]** shares of **[insert name of company]** stock sold and reported on Form 8949, *Sales and Other Dispositions of Capital Assets,* and attached to the **[insert tax year]** Form 1040.

Other Information

Many insurers issued fixed and variable shares of common stock as compensation to policyholders for the loss of their mutual rights. In addition, many former mutual policyholders were given notices with instructions similar to the following.

> **[Name of the mutual life insurance company]** is in the process of converting to a stock corporation. You will receive a total of 56 shares of **[name of the new stock life insurance corporation]** common stock on **[date]** as compensation for the loss of your mutual rights. Because the shares you receive are less than 100, you have the right to buy 44 additional shares of **[name of the new stock life insurance corporation]** at the initial offering price (IPO) price. The IPO price will be established on **[date].** If you elect to buy the additional 44 shares, you must return the enclosed form to us no later than **[date].** Once your election to purchase the additional 44 shares is received by us, it cannot be revoked. After the IPO price is established, we will issue a statement to you that computes the amount you must remit to us for the additional 44 shares. No commission will be charged to purchase the additional 44 shares.

A practitioner whose client sells exactly 100 shares of a new stock life insurance corporation should inquire as to whether optional additional shares were purchased. If so, the additional cost must be considered in calculating the total cost basis of the 100 shares.

Example 14. Drake and Samantha owned a Prudent life insurance policy. They paid $2,180 in total premiums on the policy. When Prudent demutualized, they received 56 shares of stock and the letter above with the right to purchase 44 additional shares at the IPO price of $29.90 per share. They sent a check for $1,315.60 (44 × $29.90) for the additional shares. Later, they sold all 100 shares for $3,500.

They meet with their preparer, Gage, to prepare their tax return. Gage performs the following calculations for Form 8949.

Calculations based on the *Fisher* case:

Sales proceeds		$3,500
Basis:		
56 shares (total premiums paid)	$2,180	
44 shares at $29.90 per share	1,316	
Total basis	$3,496	(3,496)
Capital gain on sale		$ 4

Calculations based on the *Dorrance* case:

Sales proceeds		$3,500
Basis:		
56 shares	$ 0	
44 shares at $29.90 per share	1,316	
Total basis	$1,316	(1,316)
Capital gain on sale		$2,184

If Gage relies on the *Fisher* case, he will include Form 8275 with the return. If Drake and Samantha had reinvested the dividends received, Gage should add those amounts to their total basis if those additional shares are also sold.

> **Observation.** The effect of these positions on federal tax will be minimized if Drake and Samantha's capital gain is taxed at 0%. State tax treatment will likely be different.

ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) was first enacted by Congress in 1969 to correct certain perceived abuses of the regular tax system when it was discovered that numerous high-income taxpayers did not pay **any** income tax.[90] Congress found it "intolerable… for 154 individuals with adjusted gross incomes of $200,000 or more to pay no federal income tax on 1966 income."[91] In 2016 terms, $200,000 of adjusted gross income (AGI) in 1969 is comparable to more than $1.3 million today.[92]

Initially, AMT was a simple add-on tax. Over the years, changes to both regular tax and AMT have affected the application of AMT.

Currently, AMT is a separate system of taxation parallel to the regular tax system. The AMT requires taxpayers to recalculate their taxes using alternative rules. Under these rules, certain types of income that are exempt from regular tax are subject to AMT. In addition, certain deductions and credits allowed for regular tax purposes are not permitted for AMT purposes. Application of these rules creates an additional tax liability for a taxpayer who would otherwise pay less tax than Congress deems appropriate.

Historically, AMT affected few taxpayers — fewer than 1% of taxpayers in any year before 2000, according to the Congressional Budget Office.[93] However, between 1999 and 2012, the number of individual taxpayers affected by AMT increased dramatically because the income requirements and exemptions were not indexed for inflation. Beginning in 2013, the AMT exemption and exemption phaseout threshold amounts are indexed for inflation annually.[94]

Although AMT is calculated separately from regular tax, all Code provisions that apply for regular tax purposes also apply for AMT purposes, unless specifically modified by the Code, regulations, or administrative pronouncements.[95] Thus, when an item of income, exclusion, or deduction is based on AGI, AGI as computed under regular tax is used as the basis for the AMT calculation. This is also true for items based on modified adjusted gross income (MAGI).

FORM 6251

AMT is computed using Form 6251, *Alternative Minimum Tax — Individuals.*

Form 6251 has three parts.

- Part I is used to identify the amounts of the adjustments and preference items. The result of the calculations in Part I is the taxpayer's alternative minimum taxable income (AMTI). The starting point for calculating AMT on line 1 of Form 6251 is the taxpayer's:
  - **AGI** if the taxpayer does not claim any itemized deductions, or
  - The taxpayer's income after itemized deductions if the taxpayer itemizes.
- Part II is used to report the taxpayer's exemption amount and compute the taxpayer's AMT.
- Part III is used to compute AMT when the taxpayer has qualified dividends or capital gains.

> **Note.** All taxpayers are potentially liable for AMT, not just high-income taxpayers. Many practitioners consider it prudent to force their tax software to compute AMT for all tax returns regardless of whether they expect the taxpayer to be subject to AMT. Some software performs the computation automatically, but the practitioner may need to make adjustments to the software's automatic calculations.

90. *General Explanation of the Tax Reform Act of 1969.* Dec. 3, 1970. Joint Committee on Taxation. [www.jct.gov/publications.html?func=showdown&id=2406] Accessed on Jun. 24, 2016.

91. Ibid.

92. *CPI Inflation Calculator.* Bureau of Labor Statistics. [data.bls.gov/cgi-bin/cpicalc.pl?cost1=20%2C0000.00&year1=1969&year2=2016] Accessed on Jun. 21, 2016.

93. *The Individual Alternative Minimum Tax.* Jan. 15, 2010. Congressional Budget Office. [www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/01-15-amt_brief.pdf] Accessed on Jun. 24, 2016.

94. IRC §55(d)(4).

95. Treas. Reg. §1.55-1.

Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ Information about Form 6251 and its separate instructions is at *www.irs.gov/form6251.*
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074
2015
Attachment Sequence No. 32

Name(s) shown on Form 1040 or Form 1040NR | Your social security number

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, and go to line 2. Otherwise, enter the amount from Form 1040, line 38, and go to line 7. (If less than zero, enter as a negative amount.)	1		
2	Medical and dental. If you or your spouse was 65 or older, enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2.5% (.025) of Form 1040, line 38. If zero or less, enter -0-	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 in the instructions for this line	4		
5	Miscellaneous deductions from Schedule A (Form 1040), line 27	5		
6	If Form 1040, line 38, is $154,950 or less, enter -0-. Otherwise, see instructions	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	Alternative tax net operating loss deduction	11	(	)
12	Interest from specified private activity bonds exempt from the regular tax	12		
13	Qualified small business stock, see instructions	13		
14	Exercise of incentive stock options (excess of AMT income over regular tax income)	14		
15	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	15		
16	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	16		
17	Disposition of property (difference between AMT and regular tax gain or loss)	17		
18	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	18		
19	Passive activities (difference between AMT and regular tax income or loss)	19		
20	Loss limitations (difference between AMT and regular tax income or loss)	20		
21	Circulation costs (difference between regular tax and AMT)	21		
22	Long-term contracts (difference between AMT and regular tax income)	22		
23	Mining costs (difference between regular tax and AMT)	23		
24	Research and experimental costs (difference between regular tax and AMT)	24		
25	Income from certain installment sales before January 1, 1987	25	(	)
26	Intangible drilling costs preference	26		
27	Other adjustments, including income-based related adjustments	27		
28	**Alternative minimum taxable income.** Combine lines 1 through 27. (If married filing separately and line 28 is more than $246,250, see instructions.)	28		

Part II Alternative Minimum Tax (AMT)

29	Exemption. (If you were under age 24 at the end of 2015, see instructions.) **IF your filing status is . . .** — **AND line 28 is not over . . .** — **THEN enter on line 29 . . .** Single or head of household — $119,200 — $53,600 Married filing jointly or qualifying widow(er) — 158,900 — 83,400 Married filing separately — 79,450 — 41,700 If line 28 is **over** the amount shown above for your filing status, see instructions.	29		
30	Subtract line 29 from line 28. If more than zero, go to line 31. If zero or less, enter -0- here and on lines 31, 33, and 35, and go to line 34	30		
31	• If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter. • 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 64 here. • **All others:** If line 30 is $185,400 or less ($92,700 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract $3,708 ($1,854 if married filing separately) from the result.	31		
32	Alternative minimum tax foreign tax credit (see instructions)	32		
33	Tentative minimum tax. Subtract line 32 from line 31	33		
34	Add Form 1040, line 44 (minus any tax from Form 4972), and Form 1040, line 46. Subtract from the result any foreign tax credit from Form 1040, line 48. If you used Schedule J to figure your tax on Form 1040, line 44, refigure that tax without using Schedule J before completing this line (see instructions)	34		
35	**AMT.** Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 13600G Form **6251** (2015)

Part III Tax Computation Using Maximum Capital Gains Rates

Complete Part III only if you are required to do so by line 31 or by the Foreign Earned Income Tax Worksheet in the instructions.

36	Enter the amount from Form 6251, line 30. If you are filing Form 2555 or 2555-EZ, enter the amount from line 3 of the worksheet in the instructions for line 31	36		
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 in the instructions for Schedule D (Form 1040), whichever applies (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	37		
38	Enter the amount from Schedule D (Form 1040), line 19 (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	38		
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 refigured for the AMT, if necessary). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	39		
40	Enter the **smaller** of line 36 or line 39	40		
41	Subtract line 40 from line 36	41		
42	If line 41 is $185,400 or less ($92,700 or less if married filing separately), multiply line 41 by 26% (.26). Otherwise, multiply line 41 by 28% (.28) and subtract $3,708 ($1,854 if married filing separately) from the result ▶	42		
43	Enter: • $74,900 if married filing jointly or qualifying widow(er), • $37,450 if single or married filing separately, or • $50,200 if head of household.	43		
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 in 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 the amount from Form 1040, line 43; if zero or less, enter -0-. If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	44		
45	Subtract line 44 from line 43. If zero or less, enter -0-	45		
46	Enter the **smaller** of line 36 or line 37	46		
47	Enter the **smaller** of line 45 or line 46. This amount is taxed at 0%	47		
48	Subtract line 47 from line 46	48		
49	Enter: • $413,200 if single • $232,425 if married filing separately • $464,850 if married filing jointly or qualifying widow(er) • $439,000 if head of household	49		
50	Enter the amount from line 45	50		
51	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 19 of the Schedule D Tax Worksheet, whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter the amount from Form 1040, line 43; if zero or less, enter -0-. If you are filing Form 2555 or Form 2555-EZ, see instructions for the amount to enter	51		
52	Add line 50 and line 51	52		
53	Subtract line 52 from line 49. If zero or less, enter -0-	53		
54	Enter the smaller of line 48 or line 53	54		
55	Multiply line 54 by 15% (.15) ▶	55		
56	Add lines 47 and 54	56		
	If lines 56 and 36 are the same, skip lines 57 through 61 and go to line 62. Otherwise, go to line 57.			
57	Subtract line 56 from line 46	57		
58	Multiply line 57 by 20% (.20) ▶	58		
	If line 38 is zero or blank, skip lines 59 through 61 and go to line 62. Otherwise, go to line 59.			
59	Add lines 41, 56, and 57	59		
60	Subtract line 59 from line 36	60		
61	Multiply line 60 by 25% (.25) ▶	61		
62	Add lines 42, 55, 58, and 61	62		
63	If line 36 is $185,400 or less ($92,700 or less if married filing separately), multiply line 36 by 26% (.26). Otherwise, multiply line 36 by 28% (.28) and subtract $3,708 ($1,854 if married filing separately) from the result	63		
64	Enter the **smaller** of line 62 or line 63 here and on line 31. If you are filing Form 2555 or 2555-EZ, do not enter this amount on line 31. Instead, enter it on line 4 of the worksheet in the instructions for line 31	64		

ADJUSTMENTS AND PREFERENCES

Adjustments are items of income and deductions that are computed differently for AMT than for regular tax purposes. They can increase or decrease AMTI.

Preferences are items receiving preferential tax treatment for regular tax purposes but not for AMT purposes. They can only increase AMTI.

> **Note.** A preference item may result in a basis difference that causes a negative adjustment in later years. For example, for regular tax purposes, the exercise of a qualified incentive stock option (ISO) is excluded from taxable income. The basis in the stock is the amount paid. For AMT purposes, the difference between the value of the stock when the ISO is exercised and the amount paid for the stock is included in income. The basis of the stock for AMT purposes is the amount paid plus the income reported for AMT purposes in the year of the exercise. When the taxpayer sells the stock, the capital gain or loss for AMT purposes is different than the gain or loss for regular tax purposes. This difference is adjusted on line 17 of Form 6251. ISO adjustments are discussed in detail later.

Adjustments and preferences can be either **deferral items** (timing differences) or **exclusion items** (permanent differences). Deferral items generate a **minimum tax credit (MTC)** which can be used to reduce regular tax in future years when the taxpayer does not owe AMT.[96] In contrast, exclusion items do not generate an MTC. The MTC is discussed in more detail later in this section.

Common Adjustments and Preferences

The most common adjustments and preference items are shown in the following list. All of these are exclusion items; thus, they are not included in the MTC. Most professional-grade tax software automatically adjusts for these items.

1. Personal exemptions
2. Standard deduction
3. Medical expenses
4. Itemized deductions for taxes paid
5. Miscellaneous itemized deductions
6. Overall limitation on itemized deductions

Personal Exemptions. Personal exemptions are not deductible for AMT purposes.[97] This adjustment alone can create AMT for large families with high incomes.

Standard Deduction. The basic standard deduction is not allowed for AMT purposes, nor are the additional standard deductions for those who are blind or age 65 or older.[98]

Tax Planning. Taxpayers who owe AMT and claim the standard deduction should **elect to itemize** even though their itemized deductions are less than the standard deduction. Taxpayers who claim the standard deduction for regular tax purposes cannot itemize for AMT purposes.[99] However, if some of the itemized deductions are allowed for AMT purposes, it may create a better tax result than having the entire standard deduction excluded.

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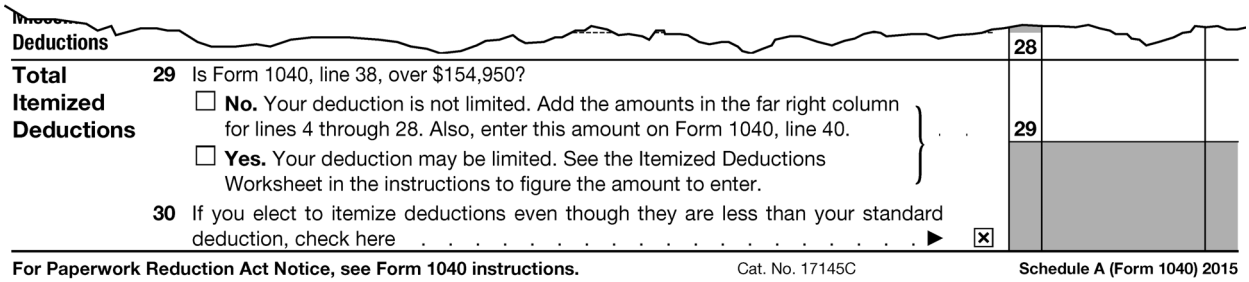
96. IRC §53(c).
97. IRC §56(b)(1)(E).
98. Ibid.
99. Instructions for Form 6251. See also *David Marx v. Comm'r,* TC Summ. Op. 2003-23 (Mar. 19, 2003).

To make this election, the taxpayer files Schedule A, *Itemized Deductions*, with their return and checks the box on line 30. It is critical that state taxes also be considered before making this election, because many states require that the same method (standard or itemized deductions) be used on the state return.



Deductions

			28
Total Itemized Deductions	29	Is Form 1040, line 38, over $154,950? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. ☐ **Yes.** Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.	29
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here . . . . . ▶ ☒	

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 17145C **Schedule A (Form 1040) 2015**

Practitioner Tip. Most tax software programs optimize the choice of claiming either the standard deduction or itemized deductions for regular tax purposes. If the taxpayer incurs AMT, the tax return preparer should verify that the method chosen is also the best for AMT purposes.

Example 15. Janet is single. In 2015, her only income consisted of $125,000 in wages. Her standard deduction of $6,300 was larger than her itemized deductions of $5,125 ($3,125 taxes + $2,000 charitable contributions). Janet also had a $25,000 AMT adjustment for the exercise of ISOs.

Janet's total tax when claiming the standard deduction is calculated as follows.

AGI	$125,000
Standard deduction	(6,300)
Exemption	(4,000)
Taxable income	$114,700
Regular tax	$ 25,187
AMT	1,879
Total tax	$ 27,066

Example 16. Use the same facts as **Example 15,** except Janet elected to itemize her deductions. Although Janet's $3,125 of taxes did not reduce her AMT, by making this election, Janet's $2,000 in charitable contributions reduced both her regular income tax and AMT. Her total tax using this method is calculated as follows.

AGI	$125,000
Itemized deductions	(5,125)
Exemption	(4,000)
Taxable income	$115,875
Regular tax	$ 25,516
AMT	900
Total tax	$ 26,416

By using the election to itemize deductions, Janet saved $650 in federal income taxes ($27,066 − $26,416).

Medical Expenses. For AMT purposes, only medical expenses exceeding 10% of AGI are deductible.[100] However, for tax years beginning after 2012 and ending before 2017, taxpayers age 65 and older qualify for the lower 7.5% floor for regular tax purposes.[101] Therefore, taxpayers who are 65 or older may have an AMT adjustment for medical expenses. The adjustment is reported on line 2 of Form 6251.

Example 17. Nathan's 2016 AGI is $50,000, and he has $6,000 of medical expenses. Nathan turned 66 on October 31, 2016. His deductible medical expenses are calculated as follows.

	Regular Tax		AMT	
Medical expenses		$6,000		$6,000
AGI	$50,000		$50,000	
	× 7.5%		× 10%	
Floor for medical expenses	$ 3,750	(3,750)	$ 5,000	(5,000)
Deductible medical expenses		$2,250		$1,000

Medical expenses of $1,250 ($2,250 − $1,000) are added back as an adjustment on line 2 of Nathan's 2016 Form 6251.

State and Local Taxes. For regular tax purposes, taxpayers can itemize their state and local income taxes or their sales taxes. Taxpayers can also itemize their real estate taxes and personal property taxes for regular tax purposes. None of these taxes are allowable deductions for AMT purposes.[102] However, any taxes deducted in computing AGI, such as the deduction for half of self-employment taxes, are **not** added back for AMT purposes.[103]

> **Note.** For taxpayers living in states with a high income tax (e.g., California and New York) or for taxpayers with high real estate taxes, this adjustment for AMT purposes can effectively eliminate any federal tax benefit from having paid such high state and local taxes.

The amount of taxes claimed as an itemized deduction on Schedule A is entered on line 3 of Form 6251.

Example 18. Laurie claims state income taxes of $2,500 and real estate taxes of $4,250 on her 2016 Schedule A. She also claims real estate taxes of $3,100 on her 2016 Schedule E, *Supplemental Income and Loss.*

For AMT purposes, Laurie must add back the $6,750 of taxes she deducts on Schedule A. No adjustment is necessary for the $3,100 of taxes she deducts on Schedule E.

Tax Planning. Taxpayers should determine the optimum year for paying taxes in order to maximize the impact of the tax deduction. Taxpayers derive no tax benefit from **prepaying** their fourth quarter state estimated tax payment if they are subject to AMT. Taxpayers who are not subject to AMT in the current year may want to prepay their fourth quarter state estimated tax payment if they are likely to be subject to AMT in the following year. This same strategy works for real estate taxes and personal property taxes when the allowable payment period extends over two calendar years.

100. IRC §56(b)(1)(B).

101. IRC §213(f).

102. IRC §56(b)(1)(A)(ii).

103. IRC §56(b)(1)(A).

Example 19. Katie plans to exercise her ISOs as soon as she is eligible in March 2017. Preliminary tax planning indicates that exercising the options will make her subject to AMT in 2017. Katie's tax professional tells her that she should prepay her fourth quarter state estimated tax payment on or before December 31, 2016. In doing so, Katie receives the benefit of the regular tax deduction on her 2016 return. This deduction would be wasted on her 2017 return because of AMT.

Taxpayers may also want to consider capitalizing certain real estate taxes when the tax benefit for a current deduction is lost due to AMT. Taxes paid for unproductive and unimproved land can be deducted on Schedule A. However, instead of deducting the expense, an election can be made to capitalize these taxes as part of the cost basis of the land.[104] **This election is made on a yearly basis by attaching a statement to the original or amended return filed by the original or extended due date.[105]**

Generally, a current deduction at regular income tax rates is more beneficial than an increase in basis that results in a future reduction in capital gains tax. However, if a taxpayer owes AMT, there is no regular tax benefit for the deduction.

Example 20. Dory paid $10,000 of real estate taxes on unimproved and unproductive land in both 2014 and 2015. The property was sold in 2015. Dory is in the 33% federal bracket in both years for regular taxes and the 15% bracket for capital gains. **She is subject to AMT in 2014 but not in 2015.**

She did not make the election to capitalize the taxes in either year, because she did not know it was an option. There was no tax savings in 2014 because she was subject to AMT and the taxes were added back for AMT purposes. In 2015, Dory saved $3,333 in income taxes for the real estate tax deduction ($10,000 real estate tax deduction × 33% tax rate). There is no impact on her capital gains. Her total tax benefit is $3,333.

Example 21. Use the same facts as **Example 20,** except Dory elects to capitalize the real estate taxes in both years. Consequently, the property's basis increases by $20,000. This results in income tax savings of $3,000 when the property is sold ($20,000 basis increase × 15% capital gains tax rate). The total tax benefit is $3,000 in the year of sale but she lost the tax benefit for the $10,000 deduction. The lost deduction cost Dory $3,333 in regular tax in 2015.

Example 22. Use the same facts as **Example 20,** except Dory elects to capitalize the taxes in 2014 and deduct the taxes in 2015. The property's basis increases by $10,000 from the 2014 capitalization, which results in income tax savings of $1,500 when the property is sold ($10,000 basis increase × 15% capital gains tax rate). Dory saves $3,333 in **2015** federal taxes from the real estate tax deduction. The total tax benefit is $4,833 ($3,333 + $1,500).

Miscellaneous Itemized Deductions. For regular tax purposes, a taxpayer may deduct miscellaneous itemized deductions in excess of 2% of AGI. This deduction is **not allowed** for AMT purposes.[106] The adjustment is reported on line 5 of Form 6251.

Overall Limit on Itemized Deductions. For regular tax purposes, itemized deductions are limited once a taxpayer reaches a certain income threshold. This is sometimes referred to as the Pease[107] limitation, which was permanently reinstated for tax years after 2012.

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104. Treas. Reg. §1.266-1(b)(1)(i).

105. Treas. Reg. §§1.266-1(c)(2) and (3).

106. IRC §56(b)(1)(A)(i).

107. Representative Donald Pease of Ohio drafted the original provision that was in effect from 1991 through 2009. The American Taxpayer Relief Act of 2012 permanently reinstated the limitation for tax years after 2012.

The Pease limitation reduces itemized deductions by the lesser of:

1. 3% of the amount of AGI exceeding the threshold, or
2. 80% of the itemized deductions that would otherwise be allowable.[108]

Certain deductions are not subject to the Pease limitation. These include the following.

- Medical and dental expenses
- Investment interest
- Casualty and theft losses
- Gambling losses

The Pease limitation is triggered when AGI exceeds the following threshold amounts for 2016.[109]

Filing Status	AGI at which Limitation Begins
Single	$259,400
MFJ and QW	311,300
MFS	155,650
HoH	285,350

This limitation does **not** apply to the computation of AMT.[110] To remove the limitation for AMT purposes, line 9 of the itemized deductions worksheet (found in the instructions for Schedule A) is entered as a negative number on line 6 of Form 6251.

108. IRC §68(a).

109. Rev. Proc. 2015-53, 2015-44 IRB 615.

110. IRC §56(b)(1)(F).

Example 23. Brad and Angie filed a joint tax return for 2015. Their AGI was $400,000, and their itemized deductions before any limitations totaled $89,250, which consisted entirely of charitable contributions.

Brad and Angie's itemized deductions were limited for regular tax purposes because their AGI exceeded the 2015 threshold limitation of $309,900.[111] The limitation is computed by completing the itemized deduction worksheet in the instructions to Schedule A, which follows.

Itemized Deductions Worksheet—Line 29 *Keep for Your Records*

1.	Enter the total of the amounts from Schedule A, lines 4, 9, 15, 19, 20, 27, and 28		1.	89,250
2.	Enter the total of the amount from Schedule A, lines 4, 14, and 20, plus any gambling and casualty or theft losses included on line 28		2.	
	CAUTION Be sure your total gambling and casualty or theft losses are clearly identified on the dotted lines next to line 28.			
3.	Is the amount on line 2 less than the amount on line 1?			
	☐ No. STOP Your deduction isn't limited. Enter the amount from line 1 of this worksheet on Schedule A, line 29. **Don't** complete the rest of this worksheet.			
	☒ Yes. Subtract line 2 from line 1		3.	89,250
4.	Multiply line 3 by 80% (0.80)	4. 71,400		
5.	Enter the amount from Form 1040, line 38	5. 400,000		
6.	Enter $309,900 if married filing jointly or qualifying widow(er); $284,050 if head of household; $258,250 if single; or $154,950 if married filing separately	6. 309,900		
7.	Is the amount on line 6 less than the amount on line 5?			
	☐ No. STOP Your deduction isn't limited. Enter the amount from line 1 of this worksheet on Schedule A, line 29. **Don't** complete the rest of this worksheet.			
	☒ Yes. Subtract line 6 from line 5	7. 90,100		
8.	Multiply line 7 by 3% (0.03)	8. 2,703		
9.	Enter the **smaller** of line 4 or line 8		9.	2,703
10.	**Total itemized deductions.** Subtract line 9 from line 1. Enter the result here and on Schedule A, line 29		10.	86,547

For regular tax purposes, Brad and Angie's total itemized deductions for 2015 are limited to the amount on line 10 of the worksheet, or $86,547. For AMT purposes, Brad and Angie had a subtraction adjustment of $2,703 on line 6 of Form 6251 because charitable contributions are not an AMT preference item and are fully deductible in the calculation of AMTI.

111. 2015 Instructions for Schedule A.

Complex Adjustments and Preferences

Certain tax situations require extra attention when AMT is a factor in the tax return. The following situations may require the practitioner to make adjustments to the automatic calculations made by their tax preparation software.

1. Home mortgage interest related to nonacquisition debt
2. Refunds of taxes previously deducted
3. Incentive stock options

Home Mortgage Interest.[112] For regular tax and AMT purposes, taxpayers can deduct qualified residence interest on their principal residence and one other residence.[113] Qualified residence interest includes interest on **acquisition indebtedness,** which is debt used to **acquire, construct, or improve** the residence. The loan must be secured by that residence. Total acquisition indebtedness is limited to $1 million.[114]

Home mortgage indebtedness incurred in connection with a divorce or legal separation is considered acquisition indebtedness. If one spouse incurs debt to pay the other spouse a lump sum for their portion of the marital home, that debt is considered acquisition debt and the interest is deductible for both regular tax and AMT purposes.[115]

For regular tax purposes, taxpayers can also deduct interest in connection with **home equity indebtedness** on a qualified residence.[116] Home equity indebtedness is defined as any debt **other than acquisition debt** that is secured by a qualified residence.[117] However, any home equity indebtedness incurred as part of the purchase, construction, or improvement of the home is also qualified debt for purposes of the interest deduction.[118] Total home equity indebtedness is limited to $100,000.[119]

> **Note.** Starting with information returns **filed** after December 31, 2016, lenders must report the outstanding principal at the beginning of the calendar year, the date of the origination of the mortgage, and the address of the property securing the mortgage on Form 1098, *Mortgage Interest Statement*.[120] This will make it easier for practitioners to adjust the mortgage interest deduction when the outstanding balance exceeds the Code limits.

For AMT purposes, the home mortgage interest deduction, including home equity interest, is **generally limited** to interest on acquisition indebtedness.[121]

> **Example 24.** Peter and Alicia deducted $12,000 of home mortgage interest on their 2015 Schedule A. The interest is composed of $10,000 from the original mortgage used to acquire the home and $2,000 from a home equity loan.
>
> They used the proceeds from the home equity loan to completely renovate the kitchen. No AMT adjustment was required because the proceeds from the home equity loan were used to improve the residence.

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112. IRC §163(h)(3).
113. IRC §§163(h)(3)(A)(i) and (4)(A)(i).
114. IRC §163(h)(3)(B)(ii).
115. Temp. Treas. Reg. §1.163-10T.
116. IRC §163(h)(3)(B).
117. IRC §163(h)(3)(C).
118. Rev. Rul. 2010-25, 2010-44 IRB 571.
119. IRC §163(h)(3)(C)(ii).
120. IRC §6050H(b) as amended by PL 114-41 (the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015).
121. IRC §56(e).

Example 25. Use the same facts as **Example 24,** except Peter and Alicia used the home equity loan to pay the legal fees incurred to defend Peter in a criminal case. Because the home equity loan was not used to improve their home, Peter and Alicia could not deduct the $2,000 interest for AMT purposes.

This is illustrated using the worksheet from the Form 6251 instructions.

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) and any mortgage insurance premiums you deducted on line 13 of Schedule A (Form 1040)	1.	12,000
2.	Enter the part, if any, of the interest included on line 1 above that was paid on an eligible mortgage (defined in the line 4 instructions). Include any mortgage insurance premiums included on line 1 above that were paid in connection with an eligible mortgage	2. 10,000	
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. Include any mortgage insurance premiums included on line 1 above that were paid in connection with such a mortgage. Do not include any interest paid on (or any mortgage insurance premiums paid in connection with) 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.	
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). Do not include any amount entered on line 2 or line 3 above	4.	
5.	Add lines 2 through 4	5.	10,000
6.	Subtract line 5 from line 1 and enter the result on Form 6251, line 4	6.	2,000

For AMT purposes, interest on a second home is only deductible if the second home is a qualified dwelling. A **qualified dwelling** is any house, apartment, condominium, or mobile home not used on a transient basis.[122]

For regular tax purposes, interest paid on a **boat or motor home** can qualify as home mortgage interest.[123] However, interest paid on a boat or motor home used as a second home is **not** deductible for AMT purposes.[124]

Example 26. Matthew purchased a boat that he uses as his second home. The boat has sleeping, cooking, and toilet facilities. In 2016, Matthew pays $4,000 interest on the acquisition loan secured by the boat. Matthew can deduct the $4,000 interest for regular tax purposes but **not** for AMT purposes.

For AMT purposes, interest paid on a mortgage that is refinanced is deductible **to the extent** that the loan amount is not increased.[125]

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122. IRC §56(e)(2).

123. IRS Pub. 936, *Home Mortgage Interest Deduction*.

124. IRC §56(e)(2).

125. Rev. Rul. 2005-11, 2005-14 IRB 816.

Example 27. In 2010, Leonard and Penny financed the purchase of their new home with a $200,000 mortgage. In 2015, when their mortgage balance was $180,000, they refinanced and received a new loan for $210,000. For AMT purposes, Leonard and Penny can only deduct interest on $180,000 of the new mortgage. Interest on the additional $30,000 is not qualifying interest unless the $30,000 was used to substantially improve the home.

The amount of home mortgage interest deducted on Schedule A that is **not** deductible for AMT purposes is entered on line 4 of Form 6251. As previously explained, this adjustment must include interest on boats, motor homes, and nonacquisition debt.

Practitioner Tip. Some tax preparation software allows for a separate identification of mortgage interest that qualifies as a deduction for AMT purposes. Other software requires that the adjustment be manually calculated.

Tax Planning. Because interest on home equity indebtedness is generally not deductible for AMT purposes, taxpayers should maintain adequate records to trace the uses of the loan proceeds. If the money is used to substantially improve the residence, then interest on the loan is deductible for AMT purposes. If the taxpayer can trace the proceeds to an investment, a passive activity, or a business, it may be possible to classify the interest paid as a different type of deductible interest.

Taxpayers must maintain the necessary records to properly trace debt repayments. Loan amounts allocated to personal expenditures are treated as repaid first.[126] Repayment of personal expenditure debt eventually reduces the debt to the point at which interest on the debt is entirely deductible for both regular tax and AMT purposes.

Example 28. In 2010, Olive financed the original purchase of her home with a $100,000 mortgage. In 2015, when her mortgage balance was $80,000, she refinanced and received a new loan for $110,000. Olive used the additional cash proceeds for personal purposes.

This new loan has two components — $80,000 of acquisition debt (interest deductible for both regular tax and AMT purposes) and $30,000 of home equity debt (interest not deductible for AMT purposes).

In 2016, Olive makes principal payments totaling $2,000. The two components of her loan are now $80,000 of acquisition debt and $28,000 of home equity debt.

Refunds of Taxes Previously Deducted. Because the itemized deduction for state and local income tax is not allowed for AMT purposes, any income tax recovery that is included in income for regular tax purposes is deducted from AMTI.[127] This exclusion applies regardless of whether the taxpayer was subject to AMT in the year of the deduction.

Example 29. In 2015, Tyrell claimed an $8,000 itemized deduction for state and local income taxes. He was **not** subject to AMT.

In 2016, Tyrell received a $2,000 state and local income tax refund. He reports this $2,000 as income for regular tax purposes, and he excludes this $2,000 from income for AMT purposes.

126. Temp. Treas. Reg. §1.163-8T(d)(1). See also IRS Pub. 936, *Home Mortgage Interest Deduction.*

127. IRC §56(b)(1)(D).

Line 7 of Form 6251 is used to deduct any state and local income tax refunds included in taxable income on line 10 of Form 1040, *U.S. Individual Income Tax Return*. Line 7 should also include any other tax refunds (e.g., personal property and real property tax refunds) included as other income on line 21 of Form 1040.

> **Practitioner Tip.** Typically, tax preparation software automatically computes this adjustment for tax refunds of state and local income tax. Tax refunds included in line 21 of Form 1040 (other income) may not be automatically calculated by the software. The return preparer should review the software's instructions in order to properly report these amounts.

If a taxpayer is subject to AMT in the year the taxes are deducted for regular tax purposes, then to the extent **no tax benefit was received** from the deduction, the **refund is excluded from income** for both regular tax and AMT purposes.[128]

Example 30. Use the same facts as **Example 29,** except Tyrell was subject to AMT in 2015 and the $8,000 of state and local income taxes was excluded for AMT purposes. Tyrell's 2015 federal income taxes consisted of the following.

Regular tax	$102,490
AMT	3,002
Total tax	$105,492

If Tyrell had **not** deducted the $2,000 of state and local taxes that was refunded in 2016, his 2015 tax liability would have consisted of the following.

Regular tax	$103,150
AMT	2,342
Total tax	$105,492

Because the total tax liability was the same with or without the $2,000 deduction for the refunded taxes, Tyrell did not receive any tax benefit for the deduction in 2015. Therefore, the $2,000 refund is excluded from Tyrell's 2016 income.

> **Practitioner Tip.** Because the determination of the tax benefit received from expenses that were recovered in a subsequent tax year requires a recalculation of the prior year's tax, tax preparation software may not automatically exclude the recovered expense from income.

Incentive Stock Options. For regular tax purposes, taxpayers can defer income tax on income from ISOs until they sell the stock. The taxpayer is not taxed on either the receipt of the option or the subsequent exercise of the option. It is only when the stock is sold that the taxpayer is taxed on the difference between the sales price and the amount they paid when they exercised the option.[129]

For AMT purposes, the difference between the option price and the fair market value (FMV) at the time of exercise is an AMT adjustment.[130] Unless the stock is sold in the same tax year, the difference between the FMV of the stock at the date of exercise and the option price is reported on **line 14 of Form 6251**. This adjustment must be manually calculated and entered into most tax preparation software programs.

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128. IRS Pub. 525, *Taxable and Nontaxable Income.*

129. IRC §421.

130. IRC §56(b)(3).

Example 31. In 2013, Homer was granted an ISO from his employer, Burns Industries, to purchase 1,000 shares of stock at $50 per share. In January 2015, Homer exercised his option but he did not sell the stock until 2016. At the time of exercise, the stock was selling for $80 per share.

In 2015, Homer had a $30,000 AMT adjustment (($80 FMV − $50 option price) × 1,000 shares) that is reported on line 14 of Form 6251. Homer received the following Form 3921, *Exercise of an Incentive Stock Option Under Section 422(b),* from Burns Industries that reported the transfer of the option shares.

☐ CORRECTED (if checked)

TRANSFEROR'S name, street address, city or town, state or province, country, and ZIP or foreign postal code	1 Date option granted	OMB No. 1545-2129	Exercise of an Incentive Stock Option Under Section 422(b)
Burns Industries, Inc. **101 Power Plant Ave.** **Springfield, IL 62701**	**12/1/2013** 2 Date option exercised **01/15/2015**	**Form 3921** (Rev. August 2013)	

TRANSFEROR'S federal identification number	EMPLOYEE'S identification number	3 Exercise price per share	4 Fair market value per share on exercise date	Copy B For Employee
999-88-7777	**111-22-3333**	$ **50**	$ **80**	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.

EMPLOYEE'S name
Homer Simpson

Street address (including apt. no.)
1000 Groening St.

City or town, state or province, country, and ZIP or foreign postal code
Springfield, IL 62701

Account number (see instructions)

5 No. of shares transferred
1000

6 If other than TRANSFEROR, name, address, and EIN of corporation whose stock is being transferred

Form **3921** (Rev. August 2013) (keep for your records) www.irs.gov/form3921 Department of the Treasury - Internal Revenue Service

The AMT basis in stock acquired by exercising an ISO is increased by the amount of the AMT adjustment.[131] This basis adjustment must be manually tracked. When the stock is sold, the difference in basis is reported **on line 17 of Form 6251.**

Example 32. Use the same facts as **Example 31.** Homer's basis in the Burns Industries stock is $50 per share for regular tax purposes. His basis is $80 per share for AMT purposes. When Homer sells the stock in 2016 for $90 per share, he has a gain of $40 per share for regular tax purposes and a gain of $10 per share for AMT purposes. The $30,000 difference ($30 per share difference × 1,000 shares) is reported as a subtraction on line 17 of Form 6251.

Often, the exercise and sale happen at the same time in what is considered a "cashless" exercise. **There is no AMT adjustment if the stock is acquired and sold in the same tax year**.

Tax Planning. Taxpayers who own ISOs during a declining market have a unique problem. If the taxpayer exercises an option early in a tax year but continues to hold the stock while the stock price declines, the taxpayer will have a potential AMT liability even though the stock no longer has the same value. One option is for the taxpayer to dispose of the stock before yearend. Although this may result in any profits on the sale being taxed at ordinary rates, it eliminates the AMT adjustment and potentially reduces the overall tax liability.

> **Note.** The adjustment for ISOs is a deferral or timing difference adjustment that can create an MTC.

In some cases, ISO shares may be subject to **restrictions** on transferability and substantial risk of forfeiture or the shares may not be fully vested in the year of exercise. If so, the AMT adjustment is made in the tax year that the restrictions lapse.[132]

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131. Ibid.

132. IRC §83(a).

If there are restrictions on the ISO shares, the taxpayer should consider whether it would be beneficial to make **an election under IRC §83(b)** to declare the associated income for AMT purposes in the year the options are exercised instead of waiting until the year the restrictions lapse. If this election is made, **no** additional income is recognized in the year that the restrictions lapse regardless of any increase in the FMV of the stock. Additionally, when the stock is sold, any gain realized above the FMV at the time the stock was received is taxed as a capital gain.

The election must be made within 30 days of the date of the exercise and is irrevocable. Instructions for making the election are found in Treas. Reg. §1.83-2.

> **Example 33.** Use the same facts as **Example 31,** except Homer's option to purchase the 1,000 shares of Burns Industries stock was subject to various restrictions over the next two years and he cannot sell the stock until the restrictions lapse.
>
> As of the date of the exercise in 2015, the excess of FMV over option price was $30,000. Homer expected the value of the stock to increase and therefore that his income in the year the restrictions lapse would be higher.
>
> Based on projections of Homer's future income, the $30,000 adjustment has less tax impact in 2015 than a larger adjustment in a future year. Consequently, Homer filed a copy of the election with his employer and the IRS within 30 days of the date of the exercise. He also included the election with his 2015 tax return.

If the stock is forfeited before the restrictions lapse, the capital loss is based on the amount paid for the stock. The additional income previously included in income as a result of making the IRC §83(b) election is **not** added to AMT basis.[133]

> **Note.** IRC §83(b) elections for regular tax or AMT purposes are **not** valid for the receipt of qualified ISOs,[134] which are nontransferable.[135] Receiving an **option** is not the same thing as exercising the option and subsequently receiving shares of stock.
>
> The §83(b) election is also not applicable for regular tax purposes to stock received from exercising an ISO. ISOs are taxed under IRC §421. Under those rules, if a share of stock is transferred to an individual and the transfer meets the requirements of §422, then no income results to the individual when the option is granted or exercised.[136]

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133. IRC §83(b)(1).

134. *Equity (Stock) - Based Compensation Audit Techniques Guide (August 2015).* Aug. 21, 2015. IRS. [www.irs.gov/businesses/corporations/equity-stock-based-compensation-audit-techniques-guide] Accessed on Jun. 28, 2016.

135. IRS Pub. 525, *Taxable and Nontaxable Income*.

136. Ltr. Rul. 200745009 (Aug. 9, 2007).

ALTERNATIVE MINIMUM TAXABLE INCOME

AMTI is calculated by adjusting the taxpayer's regular taxable income by the AMT adjustments and preferences. This is calculated in part I of Form 6251.

Alternative Minimum Tax Exemption

The AMT exemption amount is subtracted from AMTI to arrive at net income subject to AMT. The AMT exemption amounts are listed in the following table.[137]

Filing Status	2016 AMT Exemption
Single and HoH	$53,900
MFJ and QW	83,800
MFS	41,900

Note. Taxpayers qualifying for the **head of household (HoH)** filing status are treated as single taxpayers for purposes of the AMT exemption. Taxpayers who file as **qualifying widow(er) (QW)** are treated as married filing jointly for purposes of the AMT exemption.[138]

The amount of the AMT exemption is phased out when a taxpayer's AMTI exceeds a certain threshold. Once AMTI equals or exceeds the end of the range, the AMT exemption is zero. For 2016, the beginning and end of the phaseout ranges are listed in the following table.[139]

Filing Status	Begin Phaseout	End Phaseout
Single and HoH	$119,700	$335,300
MFJ and QW	159,700	494,900
MFS	79,850	247,450

There is a separate addition to AMTI that applies to MFS taxpayers with income over certain levels. This is intended to prevent married taxpayers from filing separately to avoid the phaseout of the MFJ exemption. MFS taxpayers must increase AMTI by the lesser of:

1. 25% of the excess of AMTI over the minimum amount of income at which the exemption will be completely phased out, or
2. The exemption amount.[140]

For MFS taxpayers, the end of the phaseout range for 2016 is $247,450 and the exemption is $41,900.[141] Therefore, the AMTI increase for MFS taxpayers in 2016 is equal to the **lesser** of:

1. 25% × (AMTI – $247,450), or
2. $41,900.

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137. Rev. Proc. 2015-53, 2015-44 IRB 615.
138. IRC §55(d)(1).
139. Rev. Proc. 2015-53, 2015-44 IRB 615.
140. IRC §55(d)(3).
141. Rev. Proc. 2015-53, 2015-44 IRB 615.

Calculating AMT

As mentioned earlier, the taxpayer's AMT is calculated in part II of Form 6251. This section explains the various lines on the form used to calculate the AMT.

Line 28 — Alternative Minimum Taxable Income. AMTI is shown on line 28. It combines lines 1 through 27 and encompasses all of the taxpayer's AMT adjustments and preferences.

Line 29 — AMT Exemption. Line 29 shows the allowable AMT exemption amount after any phaseouts.

Line 30 — Subtotal. The subtotal amount reported on line 30 is the taxpayer's AMTI less their exemption amount. The amount on line 30 is used to calculate the tentative minimum tax. If this number is zero or less, the taxpayer is not subject to AMT unless they are subject to the rules for taxpayers excluding foreign earned income. A taxpayer who excludes foreign earned income on Form 2555, *Foreign Earned Income*, or Form 2555-EZ, *Foreign Earned Income Exclusion*, must make a separate calculation to determine their taxable income for AMT purposes.

Line 31 — Tax Calculation. There are only two ordinary income tax rates for AMT purposes — 26% and 28%.[142] For 2016, the top of the 26% bracket is $186,300[143] ($93,150 for MFS taxpayers). The 28% rate applies to taxable income above this threshold.

Capital gains and qualified dividends are taxed at the same rates for AMT purposes as for regular tax purposes. If the taxpayer has qualified dividends or capital gains, the tax is determined by using Part III of Form 6251.

If the taxpayer excludes foreign earned income (on Form 2555 or Form 2555-EZ), then the worksheet in the instructions for Form 6251 is used to compute AMT. For AMT purposes, the excluded foreign earned income is added back and any itemized deductions that were not deductible because the income was excluded are subtracted.

Line 32 — AMT Foreign Tax Credit.[144] For taxpayers who make the election to claim the foreign tax credit on Form 1040 without filing Form 1116, *Foreign Tax Credit,* their AMT foreign tax credit is the same as their foreign tax credit for regular tax purposes.

All other taxpayers must recalculate their foreign tax credit for AMT purposes. For regular tax purposes, the foreign tax credit is equal to the tentative federal tax multiplied by a fraction. The numerator of the fraction is foreign-source taxable income and the denominator is worldwide taxable income. For AMT purposes, foreign-source taxable income and worldwide taxable income are calculated after taking into account all AMT adjustments and preferences. Often the allocation of adjustments and preferences between the U.S. and foreign-source income changes the ratio of foreign-source taxable income to worldwide taxable income. Thus, the AMT foreign tax credit may be more or less than the foreign tax credit for regular tax purposes.

Taxpayers can elect to use a simplified method to calculate their AMT foreign tax credit. Under the simplified method, foreign-source income as calculated for regular tax purposes is used in the computation of the AMT foreign tax credit. Once this election is made, it applies to all subsequent tax years and may only be revoked with the IRS's consent.

Line 33 — Tentative Minimum Tax. The tentative minimum tax reported on line 33 is calculated by subtracting the AMT foreign tax credit on line 32 from the tax calculation on line 31.

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142. IRC §55(b)(1)(A)(i).

143. Rev. Proc. 2015-53, 2015-44 IRB 615.

144. Instructions for Form 6251.

Line 34 — Regular Tax as Adjusted. Line 34 is the taxpayer's regular tax liability (shown on line 44 of Form 1040) adjusted by the following.

1. The excess advance premium tax credit from Form 8962, *Premium Tax Credit (PTC)*, is **added** to the regular tax.
2. The tax from Form 4972, *Tax on Lump-Sum Distributions*, is **subtracted** from the regular tax.
3. The regular foreign tax credit is **subtracted** from the regular tax.
4. If the regular tax is calculated on Schedule J, *Income Averaging for Farmers,* the regular tax liability must be **recalculated without** using Schedule J to determine the amount to enter on line 34.

Line 35 — Alternative Minimum Tax. Line 35 is the difference between the tentative minimum tax on line 33 and the adjusted regular tax on line 34. If line 34 is greater than line 33, the taxpayer does not have an AMT liability. The amount on line 35 is carried to line 45 on Form 1040 as an addition to the total tax liability.

Practitioner Tip. For tax planning purposes, it is critical to keep the following points in mind.

1. When regular tax liability is close to AMT liability, the practitioner should consider advising the client about the benefits of accelerating or deferring income or deductions for the best long-term tax results.
2. When the AMT exemption amount has been completely phased out, it may be beneficial to accelerate income items. This is because the top tax rate under AMT is 28% but the top rate is 39.6% for regular tax. Consequently, accelerating income may be beneficial until the regular tax exceeds the AMT liability.

COMPREHENSIVE EXAMPLE

Example 34. Jerry and Elaine are married and have two children. Jerry works for a large production company. In 2015, he had wages of $160,000 that were reported on Form W-2, *Wage and Tax Statement.* Elaine is also employed full-time and had 2015 Form W-2 wages of $100,000. Their other 2015 income included $2,000 of qualified dividends and a long-term capital gain of $3,000.

Jerry and Elaine bought their principal residence in 2000 with an original mortgage of $150,000. The balance on the mortgage in 2015 was $100,000. In 2011, they purchased a second home that they use mostly as a summer retreat. They obtained a mortgage of $125,000 when they purchased the second home. In 2015, the balance on that mortgage was $120,000.

Jerry and Elaine's potential deductions for 2015 are as follows.

1. The mortgage interest on the principal residence and second home loans totaled $14,000.
2. Real estate taxes on the two homes totaled $12,000.
3. Jerry and Elaine paid a total of $9,750 in state income taxes.
4. They made cash charitable contributions of $2,000.
5. Jerry had $16,000 of unreimbursed employee business expenses.

Jerry has an ISO that he can exercise in 2016. He has an option to purchase 1,000 shares at $5 per share. The stock is currently trading at $20 per share. The company experienced a very successful production season, and Jerry expects the stock to continue to rise in value. His employer sent a letter regarding the ISO that advised him to seek tax advice about the exercise.

Jerry had always prepared his and Elaine's joint tax return but decided to seek assistance for the 2015 return and get some advice on the 2016 option exercise. He is considering taking out a home equity loan on his principal residence so that he would have the cash to purchase the stock as well as pay off some credit card debt.

Jerry met with George, who is a local tax practitioner. George prepared the 2015 return and ran projections for 2016. Portions of Jerry and Elaine's 2015 tax return follow.

Form 1040 (2015) Page 2

	38	Amount from line 37 (adjusted gross income)		38	265,000
Tax and Credits	39a	Check if: ☐ **You** were born before January 2, 1951, ☐ Blind. ☐ **Spouse** was born before January 2, 1951, ☐ Blind. **Total boxes checked ▶ 39a**			
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ **39b** ☐			
Standard Deduction for— • People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, $6,300 Married filing jointly or Qualifying widow(er), $12,600 Head of household, $9,250	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		40	48,450
	41	Subtract line 40 from line 38		41	216,550
	42	**Exemptions.** If line 38 is $154,950 or less, multiply $4,000 by the number on line 6d. Otherwise, see instructions		42	16,000
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	200,550
	44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐		44	42,556
	45	**Alternative minimum tax** (see instructions). Attach Form 6251		45	5,807
	46	Excess advance premium tax credit repayment. Attach Form 8962		46	
	47	Add lines 44, 45, and 46 ▶		47	48,363
	48	Foreign tax credit. Attach Form 1116 if required	48		
	49	Credit for child and dependent care expenses. Attach Form 2441	49		
	50	Education credits from Form 8863, line 19	50		
	51	Retirement savings contributions credit. Attach Form 8880	51		
	52	Child tax credit. Attach Schedule 8812, if required	52		
	53	Residential energy credits. Attach Form 5695	53		
	54	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐	54		
	55	Add lines 48 through 54. These are your **total credits**		55	
	56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- ▶		56	48,363
	57	Self-employment tax. Attach Schedule SE		57	

For Example 34

SCHEDULE A (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Information about Schedule A and its separate instructions is at *www.irs.gov/schedulea*.
▶ Attach to Form 1040.

OMB No. 1545-0074
2015
Attachment Sequence No. **07**

Name(s) shown on Form 1040: **Jerry & Elaine Client**

Your social security number: 987-65-4321

Medical and Dental Expenses		**Caution:** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see instructions)	1			
	2	Enter amount from Form 1040, line 38 | 2 |				
	3	Multiply line 2 by 10% (.10). But if either you or your spouse was born before January 2, 1951, multiply line 2 by 7.5% (.075) instead	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	
Taxes You Paid	5	State and local **(check only one box):**				
		a ☒ Income taxes, **or**	5	9,750		
		b ☐ General sales taxes				
	6	Real estate taxes (see instructions)	6	12,000		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	21,750
Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098	10	14,000		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11			
	12	Points not reported to you on Form 1098. See instructions for special rules	12			
	13	Mortgage insurance premiums (see instructions)	13			
	14	Investment interest. Attach Form 4952 if required. (See instructions.)	14			
	15	Add lines 10 through 14			15	14,000
Gifts to Charity	16	Gifts by cash or check. If you made any gift of $250 or more, see instructions	16	2,000		
	17	Other than by cash or check. If any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	17			
	18	Carryover from prior year	18			
	19	Add lines 16 through 18			19	2,000
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See instructions.)			20	
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶ **Unreimbursed expenses**	21	16,000		
	22	Tax preparation fees	22			
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23			
	24	Add lines 21 through 23	24	16,000		
	25	Enter amount from Form 1040, line 38 | 25 | 265,000 |				
	26	Multiply line 25 by 2% (.02)	26	5,300		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	10,700
Other Miscellaneous Deductions	28	Other—from list in instructions. List type and amount ▶			28	
Total Itemized Deductions	29	Is Form 1040, line 38, over $154,950?				
		☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40.			29	48,450
		☒ **Yes.** Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.				
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐				

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 17145C **Schedule A (Form 1040) 2015**

For Example 34

Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ Information about Form 6251 and its separate instructions is at *www.irs.gov/form6251.*
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2015

Attachment Sequence No. 32

Name(s) shown on Form 1040 or Form 1040NR: **Jerry & Elaine Client**

Your social security number: **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, and go to line 2. Otherwise, enter the amount from Form 1040, line 38, and go to line 7. (If less than zero, enter as a negative amount.)	1	216,550	
2	Medical and dental. If you or your spouse was 65 or older, enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2.5% (.025) of Form 1040, line 38. If zero or less, enter -0-	2		
3	Taxes from Schedule A (Form 1040), line 9	3	21,750	
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet in the instructions for this line	4	0	
5	Miscellaneous deductions from Schedule A (Form 1040), line 27	5	10,700	
6	If Form 1040, line 38, is $154,950 or less, enter -0-. Otherwise, see instructions	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	Alternative tax net operating loss deduction	11	( )	
12	Interest from specified private activity bonds exempt from the regular tax	12		
13	Qualified small business stock, see instructions	13		
14	Exercise of incentive stock options (excess of AMT income over regular tax income)	14		
15	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	15		
16	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	16		
17	Disposition of property (difference between AMT and regular tax gain or loss)	17		
18	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	18		
19	Passive activities (difference between AMT and regular tax income or loss)	19		
20	Loss limitations (difference between AMT and regular tax income or loss)	20	0	
21	Circulation costs (difference between regular tax and AMT)	21		
22	Long-term contracts (difference between AMT and regular tax income)	22		
23	Mining costs (difference between regular tax and AMT)	23		
24	Research and experimental costs (difference between regular tax and AMT)	24		
25	Income from certain installment sales before January 1, 1987	25	( )	
26	Intangible drilling costs preference	26		
27	Other adjustments, including income-based related adjustments	27		
28	**Alternative minimum taxable income.** Combine lines 1 through 27. (If married filing separately and line 28 is more than $246,250, see instructions.)	28	249,000	

Part II Alternative Minimum Tax (AMT)

29	Exemption. (If you were under age 24 at the end of 2015, see instructions.) **IF your filing status is . . .** / **AND line 28 is not over . . .** / **THEN enter on line 29 . . .** Single or head of household — $119,200 — $53,600 Married filing jointly or qualifying widow(er) — 158,900 — 83,400 Married filing separately — 79,450 — 41,700 If line 28 is **over** the amount shown above for your filing status, see instructions.	29	60,875	
30	Subtract line 29 from line 28. If more than zero, go to line 31. If zero or less, enter -0- here and on lines 31, 33, and 35, and go to line 34	30	188,125	
31	• If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter. • 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 64 here. • **All others:** If line 30 is $185,400 or less ($92,700 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract $3,708 ($1,854 if married filing separately) from the result.	31	48,363	
32	Alternative minimum tax foreign tax credit (see instructions)	32		
33	Tentative minimum tax. Subtract line 32 from line 31	33	48.363	
34	Add Form 1040, line 44 (minus any tax from Form 4972), and Form 1040, line 46. Subtract from the result any foreign tax credit from Form 1040, line 48. If you used Schedule J to figure your tax on Form 1040, line 44, refigure that tax without using Schedule J before completing this line (see instructions)	34	42,556	
35	**AMT.** Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35	5,807	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 13600G Form **6251** (2015)

For Example 34

Form 6251 (2015) Page 2

Part III Tax Computation Using Maximum Capital Gains Rates

Complete Part III only if you are required to do so by line 31 or by the Foreign Earned Income Tax Worksheet in the instructions.

36	Enter the amount from Form 6251, line 30. If you are filing Form 2555 or 2555-EZ, enter the amount from line 3 of the worksheet in the instructions for line 31	36	188,125
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 in the instructions for Schedule D (Form 1040), whichever applies (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	37	5,000
38	Enter the amount from Schedule D (Form 1040), line 19 (as refigured for the AMT, if necessary) (see instructions). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	38	
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 refigured for the AMT, if necessary). If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	39	5,000
40	Enter the **smaller** of line 36 or line 39	40	5,000
41	Subtract line 40 from line 36	41	183,125
42	If line 41 is $185,400 or less ($92,700 or less if married filing separately), multiply line 41 by 26% (.26). Otherwise, multiply line 41 by 28% (.28) and subtract $3,708 ($1,854 if married filing separately) from the result ▶	42	47,613
43	Enter: • $74,900 if married filing jointly or qualifying widow(er), • $37,450 if single or married filing separately, or • $50,200 if head of household.	43	74,900
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 in 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 the amount from Form 1040, line 43; if zero or less, enter -0-. If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter	44	195,550
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	5,000
47	Enter the **smaller** of line 45 or line 46. This amount is taxed at 0%	47	
48	Subtract line 47 from line 46	48	5,000
49	Enter: • $413,200 if single • $232,425 if married filing separately • $464,850 if married filing jointly or qualifying widow(er) • $439,000 if head of household	49	464,850
50	Enter the amount from line 45	50	0
51	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 19 of the Schedule D Tax Worksheet, whichever applies (as figured for the regular tax). If you did not complete either worksheet for the regular tax, enter the amount from Form 1040, line 43; if zero or less, enter -0-. If you are filing Form 2555 or Form 2555-EZ, see instructions for the amount to enter	51	195,550
52	Add line 50 and line 51	52	195,550
53	Subtract line 52 from line 49. If zero or less, enter -0-	53	269,300
54	Enter the smaller of line 48 or line 53	54	5,000
55	Multiply line 54 by 15% (.15) ▶	55	750
56	Add lines 47 and 54	56	5,000
	If lines 56 and 36 are the same, skip lines 57 through 61 and go to line 62. Otherwise, go to line 57.		
57	Subtract line 56 from line 46	57	0
58	Multiply line 57 by 20% (.20) ▶	58	
	If line 38 is zero or blank, skip lines 59 through 61 and go to line 62. Otherwise, go to line 59.		
59	Add lines 41, 56, and 57	59	
60	Subtract line 59 from line 36	60	
61	Multiply line 60 by 25% (.25) ▶	61	
62	Add lines 42, 55, 58, and 61	62	48,363
63	If line 36 is $185,400 or less ($92,700 or less if married filing separately), multiply line 36 by 26% (.26). Otherwise, multiply line 36 by 28% (.28) and subtract $3,708 ($1,854 if married filing separately) from the result	63	48,967
64	Enter the **smaller** of line 62 or line 63 here and on line 31. If you are filing Form 2555 or 2555-EZ, do not enter this amount on line 31. Instead, enter it on line 4 of the worksheet in the instructions for line 31	64	48,363

Form **6251** (2015)

George informed Jerry and Elaine that they are subject to AMT. He further explained that they are not receiving any tax benefits from the following.

- The state taxes they paid
- The real estate taxes they paid
- Jerry's employee business expenses

George suggested that Jerry talk to his employer to see if the employer would be willing to renegotiate his compensation package to reduce his salary but reimburse him for some of his out-of-pocket expenses. If the accountable plan were designed to reimburse Jerry's regular expenses, it would save Medicare taxes for both Jerry and his employer. In addition, Jerry's income taxes would be reduced by replacing taxable income with nontaxable reimbursements.

George explained to Jerry and Elaine that an exercise of the ISO in 2016 without selling the stock could result in an AMT adjustment of $15,000, based on the $20 per share value compared to the $5 exercise price for 1,000 shares. He also explained that the actual adjustment depends on the FMV of the stock on the date of exercise. Jerry was not happy to learn that exercising the ISO could result in additional taxes of more than $5,000 because of the AMT adjustment and AMT phaseouts.

George suggested that Jerry consider exercising the ISO right away to start the 1-year holding period necessary for long-term capital gains. That way, if Jerry needed to sell some of the stock to pay the additional taxes, the gain would qualify for the long-term capital gains rates. He further explained that, if the value of the stock continues to rise, the amount of the AMT adjustment for 2016 would be higher if Jerry waited to exercise the ISO.

George also discussed the home equity loan with Jerry and Elaine. George told them that they cannot deduct the interest for AMT purposes if the loan proceeds are used to pay off personal credit card debt. However, if the money were used to purchase the company stock when Jerry exercises the ISO, the interest on that portion of the debt could be deducted as investment interest. George explained how important it is to trace the loan proceeds on the home equity loan.

Jerry and Elaine were happy that they sought assistance with their 2015 tax return and had a few things to think about for 2016.

THE MINIMUM TAX CREDIT

A portion of a taxpayer's AMT may generate an alternative MTC. The MTC is generated only by AMT attributable to **deferral or timing preference items.** AMT attributable to exclusion items does not affect the MTC.[145]

The theory behind the MTC is to provide relief from AMT created by items whose tax effect is temporary. For example, a depreciable asset's basis is reduced to zero under both regular tax and AMT. The difference between the two taxes is strictly a timing issue. Both regular tax and AMT allow a deduction for the total amount of the asset's basis. Therefore, any tax created by the difference between the regular tax method and the AMT method is a situation that changes over time. It is inequitable to penalize a taxpayer for timing issues without offering some relief. Unfortunately, because a taxpayer's situation varies from year to year, the MTC does not always provide total relief for the tax created by the AMT.

145. IRC §53(d)(1)(B)(i)(II).

Example 35. In 2015, Leslie placed used equipment that cost $50,000 into service. Her regular tax depreciation was $10,000 and her AMT depreciation was $7,500. Because Leslie paid AMT in 2015, she received no tax benefit from the additional $2,500 of regular depreciation. Her adjusted tax basis in the equipment was $40,000 for regular tax purposes and $42,500 for AMT purposes.

In 2016, Leslie sold the equipment for $45,000. Her gain for regular tax purposes was $5,000 ($45,000 – $40,000) and her gain for AMT purposes is only $2,500 ($45,000 – $42,500).

If Leslie also owes AMT for 2016, her reduced gain for AMT purposes automatically reduces her AMT liability. This provides her with a tax benefit for the additional $2,500 of regular depreciation that provided no benefit for her in 2015.

If Leslie does not owe AMT for 2016, she will not receive any tax benefit from the $2,500 of regular depreciation unless she can claim the MTC.

The MTC is determined using the following formula.[146]

Total AMT paid by taxpayer for all prior years beginning after 1986
– AMT attributable to exclusion items
– MTC amounts already claimed
MTC

Form 8801

In order to claim the MTC, it is necessary to know the amount of prior years' AMT that was attributable to the exclusion items. Form 8801, *Credit for Prior Year Minimum Tax,* is used to calculate the MTC and determine any possible carryforward to subsequent years.

Part I of Form 8801 calculates the net minimum tax on exclusion items from the prior year's tax information. Line 1 combines the amounts reported on lines 1, 6, and 10 from the **prior** year's Form 6251 (base income subject to AMT plus the amount of itemized deductions phased out for regular tax purposes plus the amount of the regular tax net operating loss).

Line 2 is the sum of all the exclusion items added to the prior year's AMTI on Form 6251. Exclusion items include the following adjustments and preferences.[147]

1. Medical and dental expenses
2. Taxes
3. Home mortgage interest
4. Miscellaneous itemized deductions
5. The subtraction for tax recoveries
6. Investment interest expense (whether reported on Schedule A or Schedule E)
7. Depletion difference
8. Interest from specified private activity bonds
9. 7% of the excluded gain from the sale of qualified small business stock
10. Any exclusion items identified by Schedules K-1
11. Any other adjustments included on line 27 ("other adjustments") of Form 6251

146. IRC §53(b).

147. Instructions for Form 8801. See also IRC §53(d)(1)(B).

Line 3 of Form 8801 is the net operating loss deduction based only on exclusion items.

Essentially, the rest of the lines of part I run through the computational mechanics of determining the amount of net minimum tax on exclusion items.

Part II of Form 8801 determines the amount of the MTC available, the amount applicable to the current year, and the amount to carry forward to future years. The MTC is carried forward indefinitely until it is completely used.[148] The carryforward from line 26 of the prior year's Form 8801 is entered on line 19.

Despite its name, the MTC is not a credit against AMT. The MTC is a credit against the taxpayer's regular tax liability. The MTC can be used to the extent regular tax liability exceeds AMT liability for the year. Lines 22 and 23 use the current year amounts of regular tax and AMT to apply this limitation. Consequently, the tax practitioner must calculate the taxpayer's potential AMT whenever there is an MTC available in order to determine the amount of the credit allowed.

Part III of Form 8801 is used to perform the tax computations when the taxpayer had qualified dividends or capital gains subject to lower rates on the previous year's return.

Example 36. For tax year 2014, Roger Smith, who is single, paid AMT of $7,885. The following table summarizes the key elements of his 2014 return.

AGI		$200,000
Itemized deductions		
State and local taxes	$ 5,000	
Mortgage interest on main home acquisition debt	6,000	
Mortgage interest on boat loan acquisition debt	4,000	
Total itemized deductions	$15,000	(15,000)
Form 1040, Line 41 (adjusted income after itemized deductions)		$185,000
Incentive stock option AMT adjustment		$ 30,000

Page 1 of Roger's 2014 Form 6251 follows. Because Roger did not have any qualified dividends or capital gains, he did not use Page 2 of Form 6251 for his 2014 return.

148. IRC §53(b).

For Example 36

Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

▶ Information about Form 6251 and its separate instructions is at *www.irs.gov/form6251.*
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074
2014
Attachment Sequence No. 32

Name(s) shown on Form 1040 or Form 1040NR: **Roger Smith**

Your social security number: **555-44-5565**

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, and go to line 2. Otherwise, enter the amount from Form 1040, line 38, and go to line 7. (If less than zero, enter as a negative amount.)	1	185,000	
2	Medical and dental. If you or your spouse was 65 or older, enter the **smaller** of Schedule A (Form 1040), line 4, **or** 2.5% (.025) of Form 1040, line 38. If zero or less, enter -0-	2		
3	Taxes from Schedule A (Form 1040), line 9	3	5,000	
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet in the instructions for this line	4	4,000	
5	Miscellaneous deductions from Schedule A (Form 1040), line 27	5		
6	If Form 1040, line 38, is $152,525 or less, enter -0-. Otherwise, see instructions	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	Alternative tax net operating loss deduction	11	( )	
12	Interest from specified private activity bonds exempt from the regular tax	12		
13	Qualified small business stock (7% of gain excluded under section 1202)	13		
14	Exercise of incentive stock options (excess of AMT income over regular tax income)	14	30,000	
15	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	15		
16	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	16		
17	Disposition of property (difference between AMT and regular tax gain or loss)	17		
18	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	18		
19	Passive activities (difference between AMT and regular tax income or loss)	19		
20	Loss limitations (difference between AMT and regular tax income or loss)	20		
21	Circulation costs (difference between regular tax and AMT)	21		
22	Long-term contracts (difference between AMT and regular tax income)	22		
23	Mining costs (difference between regular tax and AMT)	23		
24	Research and experimental costs (difference between regular tax and AMT)	24		
25	Income from certain installment sales before January 1, 1987	25	( )	
26	Intangible drilling costs preference	26		
27	Other adjustments, including income-based related adjustments	27		
28	**Alternative minimum taxable income.** Combine lines 1 through 27. (If married filing separately and line 28 is more than $242,450, see instructions.)	28	224,000	

Part II Alternative Minimum Tax (AMT)

29	Exemption. (If you were under age 24 at the end of 2014, see instructions.) **IF your filing status is . . .** / **AND line 28 is not over . . .** / **THEN enter on line 29 . . .** Single or head of household — $117,300 — $52,800 Married filing jointly or qualifying widow(er) — 156,500 — 82,100 Married filing separately — 78,250 — 41,050 If line 28 is **over** the amount shown above for your filing status, see instructions.	29	26,125	
30	Subtract line 29 from line 28. If more than zero, go to line 31. If zero or less, enter -0- here and on lines 31, 33, and 35, and go to line 34	30	197,875	
31	• If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter. • 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 64 here. • **All others:** If line 30 is $182,500 or less ($91,250 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract $3,650 ($1,825 if married filing separately) from the result.	31	51,755	
32	Alternative minimum tax foreign tax credit (see instructions)	32		
33	Tentative minimum tax. Subtract line 32 from line 31	33	51,755	
34	Add Form 1040, line 44 (minus any tax from Form 4972), and Form 1040, line 46. Subtract from the result any foreign tax credit from Form 1040, line 48. If you used Schedule J to figure your tax on Form 1040, line 44, refigure that tax without using Schedule J before completing this line (see instructions)	34	43,870	
35	**AMT.** Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35	7,885	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 13600G Form **6251** (2014)

For 2015, Roger completed Form 8801 to determine the amount of MTC he could claim against his 2015 regular tax liability. The key elements of his 2015 return were the same as for 2014 except he did not exercise an ISO in 2015. Roger did not owe AMT for 2015.

Roger's Form 8801 follows. An explanation of various line items is provided after the form.

Form **8801**

Department of the Treasury
Internal Revenue Service (99)

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

▶ Information about Form 8801 and its separate instructions is at *www.irs.gov/form8801*.
▶ Attach to Form 1040, 1040NR, or 1041.

OMB No. 1545-1073

2015

Attachment Sequence No. **74**

Name(s) shown on return: **Roger Smith**

Identifying number: **555-44-5565**

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 1, 6, and 10 of your 2014 Form 6251. Estates and trusts, see instructions	1	185,000	
2	Enter adjustments and preferences treated as exclusion items (see instructions)	2	9,000	
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 $242,450 and you were married filing separately for 2014, see instructions	4	194,000	
5	Enter: $82,100 if married filing jointly or qualifying widow(er) for 2014; $52,800 if single or head of household for 2014; or $41,050 if married filing separately for 2014. Estates and trusts, enter $23,500	5	52,800	
6	Enter: $156,500 if married filing jointly or qualifying widow(er) for 2014; $117,300 if single or head of household for 2014; or $78,250 if married filing separately for 2014. Estates and trusts, enter $78,250	6	117,300	
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	76,700	
8	Multiply line 7 by 25% (0.25)	8	19,175	
9	Subtract line 8 from line 5. If zero or less, enter -0-. If under age 24 at the end of 2014, see instructions	9	33,625	
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	160,375	
11	• If **for 2014** you filed Form 2555 or 2555-EZ, see instructions for the amount to enter. • If **for 2014** 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 18a and 19, column (2), of Schedule D (Form 1041)), complete Part III of Form 8801 and enter the amount from line 55 here. Form 1040NR filers, see instructions. • **All others:** If line 10 is $182,500 or less ($91,250 or less if married filing separately for 2014), multiply line 10 by 26% (0.26). Otherwise, multiply line 10 by 28% (0.28) and subtract $3,650 ($1,825 if married filing separately for 2014) from the result. Form 1040NR filers, see instructions.	11	41,698	
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	41,698	
14	Enter the amount from your 2014 Form 6251, line 34, or 2014 Form 1041, Schedule I, line 55	14	43,870	
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	0	

For Paperwork Reduction Act Notice, see instructions. Cat. No. 10002S Form **8801** (2015)

For Example 36

Form 8801 (2015) Page 2

Part II Minimum Tax Credit and Carryforward to 2016

16	Enter the amount from your 2014 Form 6251, line 35, or 2014 Form 1041, Schedule I, line 56	16	7,885	
17	Enter the amount from line 15	17	0	
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	7,885	
19	**2014 credit carryforward.** Enter the amount from your 2014 Form 8801, line 26	19		
20	Enter your 2014 unallowed qualified electric vehicle credit (see instructions)	20		
21	Combine lines 18 through 20. If zero or less, stop here and see the instructions	21	7,885	
22	Enter your 2015 regular income tax liability minus allowable credits (see instructions)	22	43,751	
23	Enter the amount from your 2015 Form 6251, line 33, or 2015 Form 1041, Schedule I, line 54	23	41,366	
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	2,385	
25	**Minimum tax credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on your 2015 Form 1040, line 54 (check box **b**); Form 1040NR, line 51 (check box **b**); or Form 1041, Schedule G, line 2c	25	2,385	
26	**Credit carryforward to 2016.** Subtract line 25 from line 21. Keep a record of this amount because you may use it in future years	26	5,500	

Form **8801** (2015)

Observations for Example 36.

- Line 2 of Form 8801 equals the 2014 exclusion items.

State and local taxes	$5,000
Mortgage interest on the boat loan	4,000
Total line 2 of Form 8801	$9,000

- Line 15 shows that Roger's minimum tax attributable to these exclusion items in 2014 was $0.
- Line 16 shows the total AMT Roger owed for 2014.
- Line 17 flows from line 15. It is $0 because none of Roger's 2014 AMT was attributable to exclusion items.
- Line 18 shows the 2014 AMT attributable to timing adjustments; in this case, the entire $7,885 of AMT was caused by the ISO.
- Lines 22 through 24 calculate the amount of the MTC that can be claimed on the 2015 return. Although Roger did not owe AMT for 2015, the MTC could not reduce his regular tax (line 22) below his minimum tax (line 23). Thus, his 2015 MTC was limited to $2,385, the amount his regular tax exceeded his minimum tax.
- The remaining $5,500 of MTC is carried forward to Roger's 2016 return. This credit carries forward indefinitely until it is completely used or Roger dies.

Note. Part III of Form 8801 is not shown in this example. Part III is not applicable because Roger did not have any capital gains or qualified dividends in 2014.

TAX SOFTWARE ISSUES

It is critical for tax practitioners to understand which entries the software makes and which must be manually entered by the return preparer. Tax preparers must understand how to compute AMT or they will not know if the computer-generated return is accurate.

As previously discussed, most professional-grade tax software properly computes the AMT adjustments for **common** adjustments and preferences. In addition to the **complex** adjustments and preferences discussed in this section, **carrybacks and carryforwards** to other tax years **might not** be handled properly by professional-grade tax software. Examples of these items include capital losses, investment interest expenses, net operating losses, passive activity losses, and foreign tax credits. Because these items are recomputed for AMT purposes, the carryback or carryforward amounts must be recomputed for AMT purposes. It may be necessary to keep a manual record of the ongoing adjustments to the carried amounts for AMT purposes.

At-risk and basis amounts may also be different for AMT purposes than for regular tax purposes (e.g., partnership basis and S corporation basis). Basis as tracked by the software should be manually checked for items not included as part of the normal data input (such as capital contributions) and for items that affect only AMT basis (such as depreciation adjustments).

Even if the software appears to be tracking AMT items, practitioners are advised to recompute the amounts to be carried back or forward and amounts affecting basis. Some types of adjustments have only been tracked by the more recent versions of software. If the AMT amounts were not entered into the software properly when first applicable, the amounts carried forward may be inaccurate. Likewise, data converted from one software provider to another may not include accurate amounts for items affected by AMT.

> **Example 37.** Prior to the 2015 tax season, Marc changed the tax software provider he had been using in his practice. The new provider transferred the data from his old software into their format, and then transferred the data into their program. The new software tracks the AMT basis of depreciable assets and prints separate reports showing the current AMT depreciation expense and the accumulated depreciation for AMT purposes.
>
> At first glance, the reports generated by the new software make it appear as though all the assets are being tracked for both regular tax and AMT purposes. However, a closer review indicates that the accumulated AMT depreciation prior to 2014 was not converted from the old software database into the new. If any of the assets are disposed of before they are fully depreciated, the new software will compute the wrong adjustment amount for Form 6251. Marc must manually correct the database so that he has the correct basis amounts for AMT purposes.