2017 Annual Federal Tax Refresher Course

6 Hours – AFTR – IRS

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COURSE OVERVIEW

COURSE DESCRIPTION
Stay ahead of the curve in a competitive tax preparation environment with this course covering all of the essential developments impacting individual tax returns during the upcoming 2016 filing season. Important tax law updates include an analysis of the extender and Affordable Care Act provisions, as well as a discussion of the personal exemption and itemized deduction phase-outs. This course also includes a review of basic individual tax preparation information needed to prepare 2016 returns and tackles some of the most challenging areas for preparers, such as determining entitlement to dependency exemptions for divorced and unmarried parents, the various methods of interest income reporting, and utilizing valuable education credits. Foreign account reporting is discussed, as is the problem of tax related identity theft. Practices, procedures, and professional responsibility requirements mandated by Circular 230 are covered to equip the practitioner with the relevant information needed to complete a successful 2016 filing season. The course content is provided in a lively fashion focusing on real-world solutions to common tax preparation problems and is replete with examples and illustrations demonstrating how to apply the relevant rules.

LEARNING OBJECTIVES
Upon completion of this course the reader will be able to:

- Recognize the relevant changes affecting 2016 individual tax returns
- Identify the applicable inflation adjustments and filing thresholds
- Determine proper dependency exemptions for clients
- Distinguish potential sources of taxable income and deductible expenses
- Identify the rules of professional responsibility applicable to preparers
ANNUAL INFLATION ADJUSTMENTS

New Filing Requirement Threshold Amounts

Citizens and residents of the United States are subject to tax on their worldwide income. Thus, regardless of where a U.S. citizen or U.S. resident lives, works, or has income, the income tax filing requirements are applicable to them.

EXAMPLE: Bill was born in the United States, making him a U.S. citizen. His parents moved with him to Canada when he was two months old and Bill has spent his entire life in Canada. He has never returned to the United States and all of his property is in Canada, including all of his bank and other financial accounts. He works in Canada and has no income from any source outside of Canada. Despite the fact that Bill has no connection with the U.S. other than having been born here, he is subject to U.S. tax filing requirements because he is a U.S. citizen. Note that there are several special rules that may apply to Bill. For example, assuming Bill is paying taxes in Canada, he would not likely owe any tax because of the foreign tax credit. Furthermore, U.S. citizens and residents living abroad may be entitled to a special exclusion for foreign source earned income1 and the foreign housing cost amount. More importantly, Bill may also be subject to the FBAR filing requirements discussed below. If so and Bill fails to file the FBAR report, he could be subject to substantial penalties. While Bill could avoid these filing requirements by renouncing or relinquishing his U.S. citizenship, doing so is not a simple process and he will still have U.S. tax filing requirements until the process is complete.

Filing requirement thresholds are based on the personal exemption and standard deduction available to a particular taxpayer. Since the personal exemption amount for 2016 is $4,050 and the 2016 standard deduction for single taxpayers is $6,300, a taxpayer who qualifies for “single” return filing status is required to file a federal income tax return for 2016 if their gross income exceeds $10,350 ($4,050 personal exemption + $6,300 standard deduction = $10,350). The following table summarizes the basic 2016 filing thresholds:

<table>
<thead>
<tr>
<th></th>
<th>Personal Exemption</th>
<th>Basic Standard Deduction</th>
<th>Filing Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$4,050</td>
<td>$6,300</td>
<td>$10,350</td>
</tr>
<tr>
<td>Married-Joint</td>
<td>$8,100</td>
<td>$12,600</td>
<td>$20,700</td>
</tr>
<tr>
<td>Married-Separate</td>
<td>$4,050</td>
<td>$6,300</td>
<td>$10,350</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$4,050</td>
<td>$9,300</td>
<td>$13,350</td>
</tr>
</tbody>
</table>

To determine the actual 2016 filing threshold, the additional standard deduction must also be taken into account. Given the availability of the additional standard deduction, the maximum filing

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1 An individual who has a tax home in a foreign country and satisfies either the bona fide foreign residence test or the foreign physical presence test may elect to exclude up to $101,300 of his or her 2016 foreign earned income from gross income in a tax year.
threshold for 2016 would apply to married taxpayers filing a joint return that are both 65 or older and both blind, in which case a federal income tax return would only have to be filed if gross income exceeded $25,600. Since the maximum over 65/blind additional standard deductions on any return is four (two for each spouse), the complete spectrum of filing thresholds for 2016 is summarized as follows:

<table>
<thead>
<tr>
<th>Number of 65 or Over/Blind Additions</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$10,350</td>
<td>$11,900</td>
<td>$13,450</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Married-Joint</td>
<td>$20,700</td>
<td>$21,950</td>
<td>$23,200</td>
<td>$24,450</td>
<td>$25,700</td>
</tr>
<tr>
<td>Married-Separate</td>
<td>$10,350</td>
<td>$11,600</td>
<td>$12,850</td>
<td>$14,100*</td>
<td>$15,350*</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$13,350</td>
<td>$14,900</td>
<td>$16,450</td>
<td>---</td>
<td>---</td>
</tr>
</tbody>
</table>

**New Personal Exemption Amounts**

The Internal Revenue Code ("Code") provides that a certain amount of a taxpayer’s income is not subject to income tax. This is achieved by allowing a deduction known as the "personal exemption" on each individual tax return. Personal exemption amounts and other deductions (either the standard deduction or itemized deductions) are subtracted from adjusted gross income ("AGI") in computing taxable income. Generally, there is allowed a personal exemption for the taxpayer and one for the taxpayer’s spouse (if filing a married-joint return) for the taxable year. There are also exemptions allowed for dependents but these are called dependent exemptions. The 2016 personal exemption amount is $4,050, up from $4,000 for 2015.

**EXAMPLE:** John and Jane file a married-joint return and have two dependents. The total personal exemption amount for their 2016 return is $8,100 ($4,050 x 2). John and Jane can also take an $8,100 dependents exemption for their two dependents ($4,050 for each dependent).

Not all taxpayers will be able to take the full amount of this exemption. The amount begins to “phase-out” once the taxpayer’s AGI reaches a certain level. For most taxpayers, the personal exemption is reduced by 2% for each $2,500 (or any fractional portion of $2,500) by which the taxpayer’s AGI exceeds a threshold amount based on the taxpayer’s filing status. For taxpayers filing married-separate returns the 2% reduction applies for each $1,250 (or any fractional portion of $1,250) by which the taxpayer’s AGI exceeds the threshold amount.

The threshold amounts for 2016 are $155,650 for taxpayers filing married-separate returns, $259,400 for single taxpayers, and $311,300 for taxpayers filing married-joint (as well as qualifying widow/widower taxpayers). Because the phase-out is 2% for each $2,500 of AGI ($1,250 in the case of married-separate taxpayers) exceeding the threshold, mathematically the personal exemptions of a taxpayer will be completely eliminated when AGI exceeds the threshold by $122,500 ($61,250 for

* Note that a taxpayer filing a married-separate return can take an additional standard deduction for his or her spouse if the spouse does not have any gross income and cannot be claimed as a dependent by another taxpayer.
married-separate taxpayers). The chart below summarizes these threshold and complete phase-out amounts for 2016 personal exemptions:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Phase-Out Begins</th>
<th>Phase-Out Complete</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Filing Jointly</td>
<td>$311,300</td>
<td>$433,800</td>
</tr>
<tr>
<td>Qualifying Widow(er)</td>
<td>$311,300</td>
<td>$433,800</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$285,350</td>
<td>$407,850</td>
</tr>
<tr>
<td>Single</td>
<td>$259,400</td>
<td>$381,900</td>
</tr>
<tr>
<td>Married Filing Separately</td>
<td>$155,650</td>
<td>$216,900</td>
</tr>
</tbody>
</table>

**EXAMPLE:** Gerry is a single taxpayer whose AGI is $325,000. As a single taxpayer, Gerry's threshold amount for the PEP is $259,400. His AGI exceeds this amount by $65,600 ($325,000 - $259,400 = $65,600). Since $65,600 divided by $2,500 is 26.24, Gerry's personal exemptions are reduced by 27 x 2%, or 54%. Remember that the reduction is for each $2,500 or fraction thereof over the AGI threshold. Fifty-four percent of $4,050 is $2,187, so for each personal exemption claimed by Gerry he will only be entitled to deduct $1,863 ($4,050 – $2,187).

While the concept of PEP is not new, the phase-out limits did not apply for tax years 2010, 2011 or 2012. They were again applicable for tax years beginning in 2013 and going forward.

Finally, it should be noted that an individual who can be claimed as a dependent by another taxpayer is not entitled to a personal exemption on his or her own return, even if the other taxpayer does not actually claim the dependency exemption or wouldn’t derive any benefit from doing so due to the PEP.

**EXAMPLE:** Kelly qualifies as a dependent of her parents, who file a married-joint return and have an AGI of $450,000. Because Kelly’s parents have an AGI above the phase-out completion amount for personal exemptions, they will get no benefit from personal exemptions (including the dependency exemption attributable to Kelly) on their married-joint return. Nonetheless, Kelly cannot take the personal exemption on her own return because she qualified as a dependent of another taxpayer. As a result, taxpayers entitled to a dependency exemption cannot simply “agree” to forego that exemption so that the dependent can take a personal exemption on his or her own return.

**New Standard Deduction Amounts**

Most taxpayers have two options with respect to determining deductions to arrive at taxable income. Generally, taxpayers may choose either the standard deduction allowed for all taxpayers with a given filing status (as detailed below) or they may instead choose to itemize their deductions on Schedule A of Form 1040. The one exception to this rule applies to married taxpayers who file married-separate returns. In that case, if one spouse chooses to itemize, the other spouse must also itemize and may not take the standard deduction; in other words, the standard deduction is zero for a taxpayer filing a married-separate return whose spouse itemizes.

**EXAMPLE:** Jim and Jill are separated and choose not to file a married-joint return. Because neither of them qualifies for the head-of-household filing status, they must each file married-separate returns. Suppose Jim has allowable deductions that exceed his standard deduction, so he chooses to itemize.
Since Jim has itemized and the couple is filing married-separate returns, Jill has a standard deduction of zero. If Jill has no deductions to itemize, she is left without any deductions to arrive at taxable income (i.e., her AGI less her personal exemption(s) will be the same as her taxable income). If Jill attempts to take the standard deduction it will be disallowed.

The standard deduction is composed of the “basic” standard deduction and an “additional” standard deduction for taxpayers who are age 65 or older, blind, or both. The amount of the basic standard deduction depends on the taxpayer’s filing status. For the 2016 tax year the basic standard deduction for single taxpayers as well as those filing married-separate returns (subject to the requirement for such taxpayers to itemize as discussed above) is $6,300. Taxpayers who qualify for the head-of-household filing status get a standard deduction of $9,300. Married taxpayers who file married-joint returns are allowed a standard deduction of $12,600 on their 2016 joint return.

For tax year 2016, the basic standard deduction of individuals who can be claimed as dependents by another taxpayer is limited to the greater of: (i) $1,050 or (ii) $350 plus the individual’s earned income for the year (limited to a maximum of $6,300).

**EXAMPLE:** Larry, Linda, and Laura are each single taxpayers who file their own returns, but each may be claimed as a dependent by other taxpayers. Larry has earned income of $600, Linda has earned income of $4,000, and Laura has earned income of $6,000. Because of the limits described above, Larry is entitled to a basic standard deduction of $1,050 (the greater of $1,050 or $600 + $350). Linda’s basic standard deduction is $4,350 (the greater of $1,050 or $4,000 + $350). Laura’s basic standard deduction is limited to $6,300, even though her earned income plus $350 would be $6,350.

For those taxpayers filing single or head-of-household returns for 2016, the additional standard deduction is $1,550. The amount of the additional standard deduction for married taxpayers (whether filing married-joint or married separate) is $1,250. Remember that an additional standard deduction is allowed for each taxpayer (i.e., both spouses on a married-joint return) who has attained the age of 65 by the end of the tax year and for each taxpayer who is blind.

**EXAMPLE:** Phyllis and Frank are married and file a joint return. Phyllis is 67 years old and blind. Frank is also blind and is 68 years old. On their married-joint return Phyllis and Frank are entitled to total additional standard deductions of $5,000 ($1,250 x 4). Since the basic standard deduction on a married-joint return is $12,600, the total standard deduction on Phyllis and Frank’s return will be $17,600 ($5,000 + $12,600).

A married taxpayer who files a married-separate return can claim an additional standard deduction based on their spouse’s age or blindness if their spouse has no gross income and cannot be claimed as a dependent of another taxpayer.

**EXAMPLE:** Paul and Margaret are married. Paul is 75 years old, blind, and has no gross income. Paul lives in a state-supported nursing home facility and is not qualified as any other taxpayer’s dependent. Margaret, who is also 75, has sufficient gross income to require that she file a federal income tax return. Even if Margaret files a married-separate return, she may claim three additional standard deductions: one for being 65 or older herself, one for Paul being 65 or older, and one for Paul being blind. Since the additional standard deduction on a married-separate return is $1,250, the total additional standard deduction on Margaret’s return will be $3,750 ($1,250 x 3). Because the basic standard deduction for a married-separate return is $6,300, Margaret is entitled to a total standard deduction of $10,050 ($6,300 + $3,750) on her federal income tax return.
For purposes of the additional standard deduction, a taxpayer is considered to have attained the age of 65 on the day before their 65th birthday.\(^2\) Thus, a taxpayer whose 65th birthday is January 1, 2017 (\(i.e.,\) a taxpayer who was born on January 1, 1952) is entitled to the additional standard deduction on his or her 2016 federal income tax return.

A taxpayer is considered blind if his or her central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his or her visual acuity, though greater than 20/200, is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. An individual who is claiming the additional standard deduction for blindness should obtain a statement from an eye doctor or registered optometrist certifying their condition.

**INCREASE IN REPAIR REGULATIONS SAFE HARBOR AMOUNT**

On September 17, 2013, the Treasury Department and the IRS issued final regulations to provide guidance on the application of Code sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property, commonly referred to as the “final tangible property regulations”. The final tangible property regulations are applicable to taxable years beginning on or after January 1, 2014. In addition to clarifying the requirements under Code sections 162(a) and 263(a), the tangible property regulations also include several simplifying provisions that are intended to ease taxpayers’ compliance with the regulations and reduce administrative burden.

For example, the final tangible property regulations provide a *de minimis* safe harbor election that permits a taxpayer to not capitalize, or treat as a material or supply, certain amounts paid for tangible property that the taxpayer acquires or produces during the taxable year, provided the taxpayer meets certain requirements and the property does not exceed certain dollar limitations. If such requirements are met, amounts paid for the qualifying property generally may be deducted under Code section 162, provided the amount otherwise constitutes an ordinary and necessary business expense in carrying on a trade or business.

Under the final tangible property regulations as original issued, a taxpayer without an applicable financial statement (“AFS”) may elect to apply the *de minimis* safe harbor if, in addition to other requirements, the amount paid for the property subject to the *de minimis* safe harbor does not exceed $500 per invoice (or per item as substantiated by the invoice). A taxpayer with an AFS may elect to apply the *de minimis* safe harbor if, in addition to other requirements, the amount paid for the property does not exceed $5,000 and the taxpayer treats the amount paid as an expense on its AFS in accordance with its written accounting procedures. The regulations define “AFS”, and it generally includes audited financial statements.

After the final tangible property regulations were issued, the Treasury Department and the IRS received numerous letters from representatives of small business taxpayers requesting that the *de minimis* safe harbor limit for taxpayers that do not have an AFS be increased. Generally, commenters felt that the $500 limitation was too low to effectively reduce the administrative burden of complying with the capitalization requirement for small business taxpayers that frequently purchase tangible property in their trades and businesses.

Taking into consideration these comments, the goal of the final tangible property regulations to reduce administrative burden, and the concern that taxpayers’ methods of accounting clearly reflect income, the *de minimis* safe harbor limitation for a taxpayer without an AFS was increased from

$500 to $2,500, effective for costs incurred during taxable years beginning on or after January 1, 2016.

**SUMMARY OF PATH ACT OF 2015 FOR INDIVIDUALS**

More than 50 taxpayer-friendly tax provisions comprise what are commonly known as the “tax extenders” because Congress typically only extends these expiring provisions for a year or two at a time. The limited extension period is due to the negative effect the provisions have on the budget. As a practical matter, many of these provisions are quasi-permanent. The research credit, for example, has been extended more than 15 times since its creation in 1981.

The 2015 extender legislation was signed into law on December 18, 2015 as part of the Protecting Americans from Tax Hikes (“PATH”) Act of 2015. The PATH Act makes many of the traditional “extender” provisions permanent. Discussed below are the extender provisions relevant to individual taxpayers that were made permanent by the PATH Act.

**Reduced Earnings Threshold for Additional Child Tax Credit**

An individual may claim a tax credit of $1,000 for each qualifying child under the age of 17. The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income (“modified AGI”) over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.

To the extent the child tax credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the “additional child tax credit”) equal to 15 percent of earned income in excess of a threshold dollar amount (the “earned income” formula). This threshold dollar amount was statutorily set as $10,000, indexed for inflation from 2001. The American Recovery and Reinvestment Act, as subsequently extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and the American Taxpayer Relief Act of 2012, set the threshold at $3,000 for taxable years 2009 to 2017. The PATH Act makes permanent the earned income threshold of $3,000.

**The American Opportunity Tax Credit**

The American Opportunity Tax Credit represents a modification to the Hope credit that was to apply only to taxable years beginning in 2009 through 2017. The PATH Act makes the American Opportunities Tax Credit (i.e., the modifications to the Hope credit) permanent.

The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

The modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. The credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability. Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion
of the modified credit is refundable if the taxpayer claiming the credit is a child who qualifies as a dependent of one of his or her parents.

**Modifications to the Earned Income Tax Credit**

A temporary provision extended by the American Taxpayer Relief Act of 2012 allows taxpayers with three or more qualifying children to claim an earned income credit of 45 percent for taxable years through 2017. Previously, the maximum credit was 40 percent and applied to taxpayers with two or more qualifying children. The PATH Act makes the 45 percent rate for taxpayers with three or more qualifying children permanent.

**Above-the-Line Deduction for Teachers**

The PATH Act permanently extends the above-the-line deduction (capped at $250) for the eligible expenses of elementary and secondary school teachers. Beginning in 2016, the provision also modifies the deduction to index the $250 cap to inflation and include professional development expenses.

**Deduction for State and Local Sales Taxes**

The PATH Act permanently extends the option to claim an itemized deduction for state and local general sales taxes in lieu of an itemized deduction for state and local income taxes. The taxpayer may either deduct the actual amount of sales tax paid in the tax year, or alternatively, deduct an amount prescribed by the IRS.

A general sales tax is a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. No deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

Taxpayers have two options with respect to the determination of the sales tax deduction amount. They can deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid or they can use tables created by the IRS that show the allowable deduction. Taxpayers who use the tables created by the IRS may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, and boats. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

**Qualified Transportation Fringes**

The PATH Act permanently extends the maximum monthly exclusion amount for transit passes and van pool benefits so that these transportation benefits match the exclusion for qualified parking benefits. These fringe benefits are excluded from an employee’s wages for payroll tax purposes and from gross income for income tax purposes. Thus, for 2016 and all subsequent years, the monthly limit on the exclusion for combined transit pass and vanpool benefits would be $250, the same as the monthly limit on the exclusion for qualified parking benefits.
100 Percent Gain Exclusion on Small Business Stock

As originally enacted, Code section 1202 allowed a taxpayer other than a corporation to exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The amount of gain eligible for the exclusion by an individual with respect to the stock of any corporation is the greater of: (1) ten times the taxpayer's basis in the stock or (2) $10 million (reduced by the amount of gain eligible for exclusion in prior years). To qualify as a small business, when the stock is issued, the aggregate gross assets (i.e., cash plus aggregate adjusted basis of other property) held by the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements. The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax. Seven percent of the excluded gain is an alternative minimum tax preference.

For section 1202 stock acquired after February 17, 2009, and before September 28, 2010, the percentage exclusion for qualified small business stock sold by an individual was increased to 75 percent. For stock acquired after September 27, 2010, and before January 1, 2015, the percentage exclusion for qualified small business stock sold by an individual was increased to 100 percent and the minimum tax preference did not apply. The PATH Act permanently extends the temporary exclusion of 100 percent of the gain on certain small business stock for non-corporate taxpayers to stock acquired and held for more than five years. This provision also permanently extends the rule that eliminates such gain as an AMT preference item.

Tax-Free Distributions from IRAs to Charities

Prior to the PATH Act, the exclusion for a “qualified charitable distribution” from an IRA would not have applied to distributions made in taxable years beginning after December 31, 2014. The provision permanently extends the ability of individuals at least 70½ years of age to exclude from gross income qualified charitable distributions from IRAs up to $100,000 per taxpayer in any tax year.

A “qualified charitable distribution” is any distribution from an IRA directly by the IRA trustee to a charitable organization. Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70 ½ and only to the extent the distribution would otherwise be includible in gross income. The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

Furthermore, a qualified charitable distribution is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

If the IRA owner has any IRA that includes nondeductible contributions, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated
as a qualified charitable distribution. Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under Code section 170.

**Charitable Deduction for Conservation Easement**

Normally, partial interests in real property (such as easements) are not eligible for the charitable contributions deduction. However, the PATH Act permanently extends the charitable deduction for contributions of real property easements for conservation purposes. The provision modifies the deduction beginning in 2016 to permit Alaska Native Corporations to deduct donations of conservation easements up to 100 percent of taxable income.

**Increased Code Section 179 Deduction**

A taxpayer may elect under Code section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to certain limitations. The PATH Act permanently extends the small business expensing limitation and phase-out amounts in effect from 2010 to 2014 ($500,000 and $2 million, respectively).

The special rules that allow expensing for computer software and qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) also are permanently extended. The provision further modifies the expensing limitation with respect to qualified real property by eliminating the $250,000 cap beginning in 2016.

The provision modifies the expensing limitation by indexing both the $500,000 and $2 million limits for inflation beginning in 2016 and by treating air conditioning and heating units placed in service in tax years beginning after 2015 as eligible for expensing.

**Provisions Affecting S Corporation Stockholders**

The PATH Act permanently extends the rule providing that a shareholder’s basis in the stock of an S corporation is reduced by the shareholder’s pro rata share of the adjusted basis of property contributed by the S corporation for charitable purposes.

The PATH Act also permanently extends the rule reducing to five years (rather than ten years) the period for which an S corporation must hold its assets following conversion from a C corporation to avoid the tax on built-in gains.

**15-Year Cost Recovery for Certain Interests in Real Property**

The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. However, exceptions exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

Specifically, Code section 168(e)(3)(E) provides a statutory 15-year recovery period for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. The PATH Act permanently extends these provisions.

The PATH Act also extended several other provisions affecting individual taxpayers. Described below are the provisions that were extended on a temporary basis.
Exclusion of Discharge of Debt Income for Home Mortgages

The PATH Act extends through 2016 the exclusion from gross income of a discharge of qualified principal residence indebtedness. The provision also modifies the exclusion to apply to qualified principal residence indebtedness that is discharged in 2017, if the discharge is pursuant to a written agreement entered into in 2016.

Above-the-Line Deduction for Qualified Tuition and Related Expenses

The PATH Act extends through 2016 the above-the-line deduction for qualified tuition and related expenses for higher education. The deduction is capped at $4,000 for an individual whose AGI does not exceed $65,000 ($130,000 for joint filers) or $2,000 for an individual whose AGI does not exceed $80,000 ($160,000 for joint filers).

The deduction is allowed in computing adjusted gross income. “Qualified tuition and related expenses” includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer’s spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.

The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

Deductibility of Mortgage Insurance Premiums

The PATH Act extends through 2016 the treatment of qualified mortgage insurance premiums as qualified residence interest for purposes of the mortgage interest deduction. This deduction phases out ratably by 10 percent for each $1,000 (or fraction thereof) by which the taxpayer’s adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer’s adjusted gross income exceeds $109,000 ($54,000 in the case of married individual filing a separate return).

Bonus First Year Depreciation

An additional first-year depreciation deduction was allowed equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2015 (January 1, 2016 for certain longer-lived and transportation property). The PATH Act extends bonus depreciation for property acquired and placed in service during 2015 through 2019 (with an additional year for certain property with a longer production period). The bonus depreciation percentage is 50 percent for property placed in service during 2015, 2016 and 2017 and phases down, with 40 percent in 2018, and 30 percent in 2019.

The PATH Act also modifies bonus depreciation to include qualified improvement property and to permit certain trees, vines, and plants bearing fruit or nuts to be eligible for bonus depreciation when planted or grafted, rather than when placed in service. The additional first-year depreciation deduction is allowed for both the regular tax and the alternative minimum tax (“AMT”). The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

Property qualifying for the additional first-year depreciation deduction must meet two basic requirements. First, the property must be: (1) property to which the modified accelerated cost


recovery system (“MACRS”) applies with an applicable recovery period of 20 years or less; (2) water utility property; (3) computer software other than computer software covered by Code section 197; or (4) qualified leasehold improvement property. Second, the original use of the property must commence with the taxpayer (i.e., it must be new).

**REVIEW OF TAX RETURN DUE DATES, INCLUDING EXTENSIONS**

**The Federal Income Tax Return**

The due date for 2016 individual federal income tax returns (Forms 1040, 1040A, and 1040EZ) is April 17, 2017, which falls on a Monday (because April 15 falls on a Saturday). Taxpayers can request an automatic six-month extension of time to file their return by filing Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, by the original due date of April 17, 2017.

If the taxpayer's return is not filed by the initial due date or by the extended due date (assuming an extension request is timely filed), the law imposes on the taxpayer a penalty of 5% of the amount of tax required to be shown on the return (less any earlier payments and credits) for the first month it is overdue, plus an additional 5% for each month (or fraction of a month) the failure continues without reasonable cause. However, the penalty is capped at 25% of the amount of tax required to be shown on the return (less any earlier payments and credits).

There is a minimum penalty for failure to file any income tax return within 60 days of the due date (including extensions), except if due to reasonable cause and not willful neglect. This minimum penalty is the lesser of $135 or the amount of tax required to be shown on the return. Thus, the minimum penalty cannot be imposed unless there is an underpayment of tax and taxpayers who owe no taxes can file late and still avoid this penalty; there is also no penalty for failure to file if a taxpayer is due a refund.

The 5% failure-to-file penalty is reduced (but not below the above minimum) by the amount of any failure-to-pay penalty (which is one-half of 1%) for that month. If the failure to file is fraudulent, however, the penalty is increased to 15% for each month (or fraction of a month) the return is overdue, up to a 75% maximum.

**The FBAR Report**

Under the Bank Secrecy Act (“BSA”), taxpayers who have a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, that had a balance of $10,000 or more at any time during 2016 are required to report the account annually by filing a Financial Crimes Enforcement Network (“FinCEN”) Form 114, *Report of Foreign Bank and Financial Accounts* (formerly Form TD F-90.22-1 and commonly known as the “FBAR” for “foreign bank account reporting”).

FBAR returns must now be received by the IRS no later than April 15. Because April 15 falls on a Saturday in 2017, the actual due date will be Monday, April 17, 2017. This is a change from previous years, when the FinCEN 114 was due by June 30. Furthermore, a six-month extension (to October 15) is now permitted. Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, has the same due date as the FinCEN 114. All FinCEN Forms 114 must be filed electronically.

The BSA E-Filing System supports electronic filing of FinCEN Form 114 (either individually or in batches) through a secure network. The BSA E-Filing System is hosted on a secure website accessible

**Business Returns**

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 changed the due dates for partnership and C corporation returns, beginning with the tax returns for the 2016 tax year. For partnership returns (Form 1065), the new due date is the 15th day of the third month following the close of the tax year. Thus, for calendar year partnerships the due date for the 2016 Form 1065 will be March 15, 2017. Partnership returns are permitted a six-month extension to September 15. These new due dates align the deadlines for partnership and S corporation returns (Form 1120S).

For C corporations, the new due date is the 15th day of the fourth month following the close of the corporation's year. Prior to the 2016 tax year, C corporation returns (Form 1120) were due on the 15th day of the third month following the close of the corporation's year. Thus, a calendar year C corporation's Form 1120 for 2016 will be due on April 17, 2017 (because April 15, 2017 falls on a Saturday). C corporations will generally be allowed a six-month extension, except that calendar-year corporations will get a five-month extension until 2026 and corporations with a June 30 year-end will get a seven-month extension until 2026. For C corporations with fiscal years ending on June 30, the new due dates will not apply until tax years beginning after December 31, 2025.

**Information Returns**

Perhaps the most common of the “information returns” required by the Code is the ubiquitous Form 1099. Information returns are required reports of activities between the taxpayer and third parties. In addition to Form 1099, Forms 1098 (Mortgage Interest Statement) W-2 (Wage and Tax Statement), 1042-S (Foreign Person's U.S. Source Income Subject to Withholding), 5498 (IRA Contribution Information), 3921 (Exercise of an Incentive Stock Option), and 3922 (Transfer of Stock Acquired through an Employee Stock Purchase Plan) are among the information returns required under the Code. Even some forms that look like tax returns are really information returns. For example, Form 990 (Return of Organization Exempt from Income Tax) is an information return, although it is often mistakenly referred to as a tax return.

The Consolidated Appropriations Act of 2016 changed the filing deadlines beginning with the 2016 tax year for Form W-2 (as well as for Forms W-2AS, W-2GU, W-2VI, W-3, W-3SS, and W-3PR). The new due date for filing these forms with the Social Security Administration is January 31, 2017 (whether you file using paper forms or electronically). Form W-2 must still be furnished to the recipient by January 31. Thus the dates for filing these returns with SSA and providing them to the recipients of the wages are now the same and there is no modified due date for filing electronically. The Form 1099 must be filed with the IRS, with the appropriate copies and other information furnished to the recipients (see discussion below). Forms 1099 are filed with the IRS accompanied by a Form 1096 if filed on paper. Note that a taxpayer filing more than 250 Forms 1099 must file them electronically. Paper filings are due on or before February 28 of the year following the calendar year in which the payment was made; electronic filers have until March 31.

The taxpayer can get an automatic 30-day extension of time to file by completing Form 8809, Application for Extension of Time to File Information Returns. The form may be submitted on paper, or through the FIRE system either as a fill-in form or an electronic file. No signature or explanation is
required for the extension. However, the taxpayer must file Form 8809 by the due date of the Forms
1099 in order to get the 30-day extension. When requesting an extension for more than 10 filers, the
taxpayer must submit the extension request online or electronically through the FIRE system. The
IRS encourages taxpayers to submit requests for 10 or fewer filers using the online fill-in form.

In all cases, the payer must furnish a payee statement to the taxpayer containing the same
information provided to the IRS. In some cases, additional information may be required. However, in
general, the payee statement must provide (1) the payer's name, address, and phone number, and
(2) the aggregate amount of payments to the taxpayer made during the year. The payee statement,
in the required form, generally must be furnished to the taxpayer by January 31 of the year following
the reportable transaction or payment. However, in the case of substitute dividends, tax-exempt
interest, gross proceeds paid to attorneys, and gross proceeds from real estate transactions, the due
date is extended to February 15 of the year following the reportable transaction or payment.

The payer may request an extension of time to furnish the statement to the taxpayer by sending a
letter to the Internal Revenue Service, Information Returns Branch, Attn: Extension of Time
Coordinator, 240 Murall Drive, Mail Stop 4360, Kearneysville, West Virginia 25430. The letter must
include: (1) the payer's name, TIN, and address; (2) the type of return; (3) a statement that an
extension of time is being requested; (4) the reason for delay; and (5) the signature of the payer or
authorized agent. The letter must be postmarked by the date on which the statements are due to
the taxpayers. If approved, a maximum of 30 days may be granted to furnish the statements.
Requests for an extension of time to furnish statements for more than 10 payers must be submitted
electronically.

**New Extension Dates**

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 directs the
IRS to modify its regulations to allow a maximum extension of 5-1/2 months for Form 1041, *U.S.
Income Tax Return for Estates and Trusts*; 3-1/2 months for Form 5500, *Annual Return/Report of
Employee Benefit Plan*; and 6 months for Form 990, *Return of Organization Exempt From Income Tax,
Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code, Form
5227, Split-Interest Trust Information Return, Form 6069, Return of Excise Tax on Excess Contributions to
Black Lung Benefit Trust Under Section 4953 and Computation of Section 192 Deduction, Form 8870,
*Information Return for Transfers Associated With Certain Personal Benefit Contracts*, and Form 3520-A,
*Annual Information Return of a Foreign Trust With a U.S. Owner*. 
DOMAIN 2: GENERAL REVIEW

TAX RELATED IDENTITY THEFT
Tax-related identity theft occurs when someone uses a stolen Social Security number ("SSN") to file a tax return claiming a fraudulent refund. Thieves also may use stolen Employer Identification Numbers ("EINs") to create false Forms W-2 to support refund fraud schemes. Among the warning signs that an individual taxpayer's SSN has been compromised is when a return is rejected with an IRS reject code indicating that the taxpayer's SSN has already been used on a filed return. Other warning signs are when the taxpayer receives IRS notices regarding a tax return after all tax issues have been resolved, refund paid or account balances have been paid or when the taxpayer receives a notice stating that they received wages from an employer unknown to them.

Warning signs for business taxpayers include when a notice is received that the return is accepted as an amended return, but the taxpayer has not filed a return for that year. Also be on the lookout for IRS notices about fictitious employees and notices regarding a defunct, closed or dormant business after all account balances have been paid.

Preparers themselves also have to be cautious regarding potential identity theft problems. Safeguarding of IRS e-file from fraud and abuse is the shared responsibility of the IRS and practitioners who are Authorized IRS e-file Providers ("Providers"). Providers must be diligent in recognizing and preventing fraud and abuse in IRS e-file and must report fraud and abuse to the IRS.

If a preparer or a taxpayer suspects that someone has stolen the taxpayer's identity and used his or her SSN for employment purposes or to file a tax return, Form 14039, Identity Theft Affidavit, should be filed. The form can be completed online, then printed and mailed to the appropriate office indicated on the form. When filing Form 14039, photocopies of at least one of the documents listed on the form to verify the taxpayer's identity should be included.

Providers must also cooperate with the IRS investigations by making available to the IRS, upon request, information and documents related to returns with potential fraud or abuse. Providers must appoint an individual as a Responsible Official who is responsible for ensuring the firm meets IRS e-file rules and requirements. Providers with problems involving fraud and abuse may be suspended or expelled from participation in IRS e-file, be assessed civil and preparer penalties or be subject to legal action.

The IRS has mandated six (6) security, privacy and business standards to better serve taxpayers and protect their information collected, processed and stored by online Providers of individual income tax returns. Compliance with these standards became mandatory January 1, 2010. The standards are based on industry best practices and are intended to supplement the Gram-Leach-Bliley Act and the implementing rules and regulations promulgated by the Federal Trade Commission.

The first of these standards is the Extended Validation SSL Certificate. This standard applies to Authorized IRS e-file Providers participating in online filing of individual income tax returns that collect taxpayer information via the Internet. These Providers must possess a valid and current Extended Validation Secure Socket Layer ("SSL") certificate using SSL 3.0 / TLS 1.0 or later and minimum 1024-bit RSA/128-bit AES.

The second standard involves External Vulnerability Scan. This standard applies to Providers participating in online filing of individual income tax returns that collect, transmit, process or store
taxpayer information. These Providers must contract with an independent third-party vendor to run weekly external network vulnerability scans of all their “system components” in accordance with the applicable requirements of the Payment Card Industry Data Security Standards (“PCI DSS”). A scanning vendor certified by the Payment Card Industry Security Standards Council and listed on their current list of Approved Scanning Vendors must perform all scans. In addition, Providers whose systems are hosted must ensure that their host complies with all applicable requirements of the PCI DSS.

For purposes of this standard, “system components” are defined as any network component, server or application that is included in or connected to the taxpayer data environment. The taxpayer data environment is that part of the network that possesses taxpayer data or sensitive authentication data. If scan reports reveal vulnerabilities, action must be taken to address the vulnerabilities in line with the scan report’s recommendations. Providers must retain weekly scan reports for at least one year. The ASV and the host (if present) must be located in the United States.

The Information Privacy and Safeguard Policies standard applies to Providers participating in online filing of individual income tax returns that own or operate a Web site through which taxpayer information is collected, transmitted, processed or stored. These Providers must have a written information privacy and safeguard policy consistent with the applicable government and industry guidelines and including the following statement: “We maintain physical, electronic and procedural safeguards that comply with applicable law and federal standards.” In addition, a privacy seal vendor acceptable to the IRS shall certify Providers’ compliance with these policies.

The fourth standard is the Web Site Challenge-Response Test. This standard applies to Providers participating in online filing of individual income tax returns that own or operate a Web site through which taxpayer information is collected, transmitted, processed or stored. These Providers must implement an effective challenge-response protocol (e.g., CAPTCHA) to protect their Web site against malicious bots. Taxpayer information must not be collected, transmitted, processed or stored unless the user successfully completes this challenge-response test.

The fifth standard, Public Domain Name Registration, applies to Providers participating in online filing of individual income tax returns that own or operate a Web site through which taxpayer information is collected, transmitted, processed or stored. These Providers must have their Web site’s domain name registered with a domain name registrar that is located in the United States and accredited by the Internet Corporation for Assigned Names and Numbers (“ICANN”). The domain name must be locked and not be private.

The final standard is Reporting of Security Incidents. This standard applies to Providers participating in online filing of individual income tax returns that collect, transmit, process or store taxpayer information. These Providers must report security incidents to the IRS as soon as possible but no later than the next business day after confirmation of the incident. For purposes of this standard, an event that can result in an unauthorized disclosure, misuse, modification or destruction of taxpayer information must be considered a reportable security incident. In addition, if the Provider’s Web site is the proximate cause of the incident, the Provider must cease collecting taxpayer information via their Web site immediately upon detection of the incident and until the underlying causes of the incident are successfully resolved.

Preparers and taxpayers should be aware that the IRS does not initiate contact with taxpayers by email, text messages or social media channels to request personal or financial information. This includes requests for PIN numbers, passwords or similar access information for credit cards, banks
or other financial accounts. “Phishing” is a scam typically carried out through unsolicited email and/or websites that pose as legitimate sites and lure unsuspecting victims to provide personal and financial information. Taxpayers and preparers should report all unsolicited email claiming to be from the IRS or an IRS-related function to: phishing@irs.gov.

**ITINS**

An Individual Taxpayer Identification Number (“ITIN”) is a tax processing number issued by the IRS. It is a nine-digit number that always begins with the number 9. The IRS issues ITINs to individuals who are required to have a U.S. taxpayer identification number but who do not have, and are not eligible to obtain, a Social Security Number from the Social Security Administration. ITINs are issued regardless of immigration status because both resident and nonresident aliens may have a U.S. filing or reporting requirement under the Internal Revenue Code.

Individuals generally must have a filing requirement and file a valid federal income tax return to receive an ITIN. There are four exceptions to this income tax return requirement. The first exception is for information reporting and/or tax withholding requirements of third parties (such as banks) who need an SSN or ITIN from an individual to comply with U.S. Treasury Regulations. The second exception is when tax withholding is required on wages, scholarships, etc. for payments to foreign individuals who otherwise do not have to file a U.S. tax return. The third exception is for mortgage interest reporting and the final exception relates to when a U.S. real property interest is acquired from a foreign person.

ITINs are for federal tax reporting only, and are not intended to serve any other purpose. The IRS issues ITINs to help individuals comply with the U.S. tax laws and to provide a means to efficiently process and account for tax returns and payments for those not eligible for Social Security Numbers. An ITIN does not authorize work in the U.S. or provide eligibility for Social Security benefits or the Earned Income Tax Credit.

A taxpayer applies for an ITIN by filing Form W-7, *Application for IRS Individual Taxpayer Identification Number*. Generally, Form W-7 must be attached to a valid federal income tax return. The taxpayer must also include originals of his or her proof of identity (or copies certified by issuing agency and foreign status documents). All returns accompanied by a W-7 should be filed at the Austin Service Center. Individuals may also apply for an ITIN using the services of an IRS-authorized “Acceptance Agent.”

ITINs may only be issued for tax purposes to individuals who are not eligible to receive a Social Security Number (“SSN”), such as a nonresident alien individual eligible to obtain the benefit of a reduced tax withholding rate under an income tax treaty, a nonresident or resident alien individual not eligible for a SSN who elects to file a joint U.S. federal income tax return with a spouse who is a U.S. citizen or resident, or an alien individual eligible to be claimed as a dependent by a U.S. taxpayer.

If an individual has an application for an SSN pending, they should not file Form W-7. Rather, they should complete Form W-7 only if and when notified by the Social Security Administration that an SSN cannot be issued. Under such circumstances, proof that the request for an SSN was denied must be included with the Form W-7.

A tax return can only be e-filed using an ITIN in the calendar year following the year in which the individual receives the ITIN. For example, if an individual applies for and receives an ITIN in 2016, he or she may not e-file any tax return (including prior year returns) using that ITIN, until 2017.
DETERMINATION OF FILING STATUS

In General

A taxpayer’s filing status depends on whether they are single or married and on their family situation. In all cases, filing status is determined on the last day of the tax year (December 31 for individuals).

In filing status lingo, taxpayers are either married or “unmarried.” A couple may be married under any one of four circumstances. First, they may be married in accordance with the statutory rules of a state (or foreign county) and sharing a residence as a married couple (even if they are actually living separately due to military service or some other reason, such as healthcare). Individuals of the same sex are considered married if they were lawfully married in a state (or foreign country) whose laws authorize the marriage of two individuals of the same sex, even if the state (or foreign country) in which they now live does not recognize same-sex marriage. As such, the term “spouse” includes an individual married to a person of the same sex if the couple is lawfully married under state (or foreign) law.

The status of a couple as being married is dependent on state or foreign law. Individuals who have entered into a registered domestic partnership, civil union, or other similar relationship that is not considered a marriage under state (or foreign) law are not considered married for federal tax purposes.

In addition to statutory marriage laws, some states recognize so-called “common law marriages.” These are marriages recognized under state law contained in judicial precedent rather than statute. Although the requirements vary, they usually include cohabitation for a specified period and some public assertion by the couple that they are married. Currently, a common law marriage can be created only in the U.S. jurisdictions of Alabama, Colorado, the District of Columbia, Iowa, Kansas, Montana, New Mexico, Rhode Island, South Carolina, Texas, and Utah. Older common law marriages may also have been created in Florida, Georgia, Idaho, Indiana, Ohio, Oklahoma, and Pennsylvania. There are only a few foreign countries that allow for the establishment of common law marriages, among them Canada, Australia, and parts of the United Kingdom.

Once a valid common law marriage has been established in a state or foreign jurisdiction that recognizes common law marriages, the marriage is valid everywhere in the U.S. and can only be dissolved through a formal divorce proceeding (there is no such thing as “common law divorce”).

Whether the marriage was established by statute or common law, a married couple that has ceased residing together is still considered married unless a court has issued a final decree of divorce or a decree of separate maintenance (in some states referred to as a “limited divorce”). Merely living apart with the intent to dissolve the marriage is insufficient – both individuals are still considered married until a court order is obtained. Furthermore, while in most states divorce decrees are final as soon as they are issued, some states may issue interlocutory decrees of divorce which do not ripen into final divorce decrees until some period of time (usually six months) after they are issued. In these states, an individual who has obtained an interlocutory decree of divorce but not a decree of separate maintenance is still considered married for tax purposes.

EXAMPLE: Fred was married for several years. Fred lives apart from his spouse and, although he does not wish to obtain a divorce for religious reasons, as of December 31, 20x1 he is in possession of a decree of separate maintenance. Phyllis has filed for divorce from her spouse. As of December 31, 20x1, she had obtained an interlocutory order of divorce which became final on January 15,
20x2. For 20x1 Fred is considered unmarried for tax purposes, although he is still legally married under his state's law. On the other hand, Phyllis's interlocutory order of divorce does not give her unmarried status for tax purposes, since the order did not become final until the following year. Unless Phyllis had previously received a decree of separate maintenance that is in force as of December 31, 20x1, she is considered married for tax purposes in 20x1.

Someone who has never been married, of course, is considered unmarried for tax purposes, as is someone whose spouse died in a prior year and who has not remarried. Note that a taxpayer is still considered married for tax purposes on December 31 of the year his or her spouse dies.

**EXAMPLE:** Donna's spouse died on January 15, 20x1. Donna remarries on December 31, 20x1. For the 20x1 tax year Donna is considered married to her new spouse and must file either a married-joint or married-separate return. The estate of Donna's deceased spouse will file a married-separate federal income tax return for the deceased spouse.

Thus a taxpayer is unmarried for tax purposes only if, as of December 31 of the tax year, the taxpayer: (1) has never been married; (2) has a spouse who died in a prior year and has not remarried; (3) has a final decree of divorce; or (4) has a decree of separate maintenance or limited divorce.

Generally, an unmarried person files a federal income tax return as “single.” A married person files either a married-joint return with his or her spouse or a married-separate return. There are two exceptions to these rules. First, a taxpayer whose spouse has died gets to file the equivalent of a married joint return for two additional years following the spouse's death if the taxpayer has a dependent child (technically referred to as the “qualifying widow/widower” filing status). The taxpayer cannot, however, file using the qualifying widow/widower status if the taxpayer has remarried before the end of the tax year for which the status could otherwise be claimed.

Second, a person who is either unmarried or “considered unmarried” may file as head-of-household if: (1) they paid more than half the cost of keeping up a home for the year; and (2) a qualifying person (generally a child or dependent parent) lived with them in the home for more than half the year (except for temporary absences, such as school). If the qualifying person is a dependent parent of the taxpayer, it is not necessary that the parent physically live in the same house as the taxpayer.

A person who is married is “considered unmarried” for this purpose if they meet all of the following requirements: (1) they file a separate return from their spouse; (2) they paid more than half the cost of keeping up their home for the tax year; (3) their spouse did not live in their home during the last 6 months of the tax year; (4) their home was the main home of their child, stepchild, or foster child for more than half the year; and (5) they can claim a dependency exemption for the child.

**Same-Sex Marriage Filing Status**

Equality of same-sex marriage for tax purposes as a result of the *Windsor* decision means that same-sex persons that are validly married under state law are now subject to the same rules as any other married persons. Pursuant to the Supreme Court's decision, for federal tax purposes the IRS looks to state or foreign law to determine whether individuals are married and the Defense of Marriage Act (“DOMA”) restrictions no longer apply.

As such, same-sex couples are generally restricted to filing married-joint or married-separate returns (see the discussion above). As with any taxpayer, a taxpayer who is married cannot file using head-of-household filing status. However, a married taxpayer may be considered unmarried and may use the head-of-household filing status if the taxpayer lives apart from his or her spouse for the
last 6 months of the taxable year and provides more than half the cost of maintaining a household that is the principal place of abode of the taxpayer’s dependent child for more than half of the year.

Although the Windsor decision ostensibly only affects 2013 and later returns, same-sex spouses who file an original tax return on or after September 16, 2013 (regardless of what year the return pertains to), must file either married-joint or married separate returns, unless they are otherwise qualified to file as head-of-household. For prior tax years for which a return has already been filed, same-sex spouses may choose (but are not required) to amend their federal income tax returns to change their filing status to married-joint or married separate, provided the period of limitations for amending the return has not expired. A taxpayer generally may file a claim for refund for three years from the date the return was filed or two years from the date the tax was paid, whichever is later.3

Even if same-sex taxpayers live in a state that does not recognize their marriage, they are still subject to the federal tax filing rules for married couples as long as they were married in a state that recognizes same-sex marriages. Note that these rules are mandatory; a same-sex taxpayer cannot elect to file a federal income tax return as single if they have been validly married in another state, even if their state of residence does not recognize that marriage.

Like other married persons, a taxpayer who is married to a person of the same sex cannot claim the standard deduction if his or her spouse itemized his or her deductions.4 Furthermore, in the past some same-sex taxpayers may have claimed their same-sex partner as a dependent. However, a taxpayer’s spouse cannot be a dependent of the taxpayer, so this is no longer an option for same-sex married couples.

Because the adoption credit is not available with respect to adopting the child of a spouse, if a taxpayer adopts the child of his or her same-sex spouse the adopting parent may not claim an adoption credit for the qualifying adoption expenses he or she pays or incurs to adopt the child.5 If a child qualifies as a dependent child of both parents who are spouses and who file married-separate returns, either parent, but not both, may claim a dependency deduction for the qualifying child. If both parents claim a dependency deduction for the child on their income tax returns, the IRS will treat the child as the qualifying child of the parent with whom the child resides for the longer period of time during the taxable year. If the child resides with each parent for the same amount of time during the taxable year, the IRS will treat the child as the qualifying child of the parent with the higher AGI.

Other tax provisions such as Code section 66 (governing treatment of community income in community property states) and Code section 469(i)(5) (providing for a $25,000 exception for rental real estate passive activity losses under some circumstances) now apply to same-sex spouses as well.

Rev. Rul. 2013-17 addresses that issue and holds that, if validly married in a state recognizing same-sex marriage, the couple is married for all federal income tax purposes:

There are more than two hundred Code provisions and Treasury regulations relating to the internal revenue laws that include the terms “spouse,” “marriage” (and derivatives thereof, such as “marries” and “married”), “husband and wife,” “husband,” and “wife.” The Service concludes that gender-neutral terms in the Code that refer to marital status, such as “spouse” and “marriage,” include,

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4 IRC § 63(c)(6)(A).
5 IRC § 23.
respectively, (1) an individual married to a person of the same sex if the couple is lawfully married under state law, and (2) such a marriage between individuals of the same sex. This is the most natural reading of those terms; it is consistent with *Windsor*, in which the plaintiff was seeking tax benefits under a statute that used the term “spouse,” 133 S. Ct. at 2683; and a narrower interpretation would not further the purposes of efficient tax administration.

In light of the *Windsor* decision and for the reasons discussed below, the Service also concludes that the terms “husband and wife,” “husband,” and “wife” should be interpreted to include same-sex spouses. This interpretation is consistent with the 5 Supreme Court's statements about the Code in *Windsor*, avoids the serious constitutional questions that an alternate reading would create, and is permitted by the text and purposes of the Code.

Thus, *Windsor* will be applied for all federal tax purposes regardless of the residency of the couple if the marriage is valid where performed. Rev. Rul. 2013-17 cautions, however, that “marriage” does not include domestic partnerships, civil unions or similar formal relationships recognized under state law that are not denominated as a marriage.

Prior to the *Windsor* decision, the value of employer-provided health care coverage for a same-sex spouse would have been included in the employee's gross income, since the marital status would be ignored for federal tax purposes and health care coverage for the same-sex spouse would not qualify for tax-free fringe benefit treatment. In light of *Windsor*, however, if such an amount was so included in the employee's gross income reported on Form W-2, that employee can now file an amended Form 1040 reflecting the employee's status as a married individual to recover federal income tax paid on the value of the health coverage of the employee's spouse. Such amendment can be done for all years for which the period of limitations for filing a claim for refund is open (generally the later of three years from the date the return was filed or two years from the date the tax was paid).

**EXAMPLE:** XYZ Company sponsors a group health plan covering eligible employees and their dependents and spouses (including same-sex spouses). Fifty percent of the cost of health coverage elected by employees is paid by XYZ. Jackie is an employee of XYZ Company and was married to Genie, a same-sex spouse, at all times during 2012. Jackie elected coverage for Genie through the group health plan beginning January 1, 2012. The value of the employer-funded portion of Genie's health coverage was $250 per month. The amount in Box 1 (“Wages, tips, and other compensation”) of Jackie's 2012 Form W-2 included $3,000 of income ($250 per month x 12 months) reflecting the value of employer-funded health coverage provided to Genie. Accordingly, Jackie filed Form 1040 for the 2012 tax year reflecting the Box 1 amount reported on Form W-2. Jackie may now file an amended Form 1040 for 2012 excluding the value of Genie's health coverage ($3,000) from gross income. The amended return will also have to update Jackie's filing status to either married-joint or married separate.

Similarly, if an employer sponsored a cafeteria plan that allowed employees to pay premiums for health coverage on a pre-tax basis, a participating employee can file an amended return to recover income taxes paid on premiums that the employee paid on an after-tax basis for the health coverage of the employee's same-sex spouse. The participating employee can file this amended return for all years for which the period of limitations for filing a claim for refund is open.

**EXAMPLE:** XYZ Company sponsors a group health plan as part of a cafeteria plan with a calendar year plan year. The full cost of spousal and dependent coverage is paid by the employees. In the open enrollment period for the 2013 plan year, Jackie elected to purchase self-only health coverage
through salary reduction under XYZ’s cafeteria plan. On March 1, 2013, Jackie was validly married to same-sex spouse Genie. Jackie purchased health coverage for Genie through XYZ’s group health plan beginning March 1, 2013. The premium paid by Jackie for Genie’s health coverage was $500 per month. The amount in Box 1 (“Wages, tips, and other compensation”) of Jackie’s 2013 Form W-2 included the $5,000 ($500 per month x 10 months) of premiums paid by Jackie for Genie’s health coverage. Jackie filed Form 1040 for the 2013 taxable year reflecting the Box 1 amount reported on Form W-2. Jackie may now file an amended Form 1040 for 2013 excluding the premiums paid for Genie’s health coverage ($5,000) from gross income. The amended return will also have to update Jackie’s filing status to either married-joint or married separate.

Same-sex married couples can now also elect to treat a jointly owned and operated unincorporated business as a “qualified joint venture” to avoid federal partnership tax treatment. A “qualified joint venture” means any joint venture involving the conduct of a trade or business if:

1. The only members of the joint venture are two spouses;
2. Both spouses materially participate in the trade or business within the meaning of the passive loss rules (but without regard to the rule that treats participation by one spouse as participation by the other); and
3. Both spouses elect the application of this rule.

The election is made by filing a joint return, together with the required schedules. Making the election results in all items of income, gain, loss, deduction, and credit are divided between the spouses according to their respective interests in the venture, and each spouse takes into account his or her respective share of these items as if they were attributable to a trade or business conducted by the spouse as a sole proprietor. Thus, each spouse will report his or her share on the appropriate form, such as a separate Schedule C filed by each spouse with their joint return.

CLAIMING A DEPENDENT

Common Requirements

As noted above, taxpayers are allowed two types of personal exemption amounts – one for themselves and one for each of their qualifying dependents. A “qualifying dependent” is either a “qualifying child” or a “qualifying relative.” Although there are different criteria that apply to each of these two types of dependents, two tests – the “citizenship or residency” test and the “joint return” test – are common to both.

Citizenship or Residency Test

A dependent must be a citizen of the United States, or a resident of the United States, Canada, Mexico, the Canal Zone, or the Republic of Panama at some time during the calendar year in which the taxpayer’s year begins. There is an exception to the residency test for adopted children. In order to qualify under the exception, a noncitizen and nonresident child must have been legally adopted and living in the same principal household as the taxpayer throughout the entire taxable year, whether the household is located in the United States or abroad. The fact that the adoption does not become final until sometime during the taxable year is immaterial, so long as the child lives in the same household as taxpayer throughout the entire taxable year. Note that, for all tax and legal purposes, including the remaining dependency requirements, a legally adopted child is treated as a child by blood of the adopting parent or parents.
**Joint Return Test**
Generally, a married individual may not be claimed as a dependent if he or she files a joint return with his or her spouse. However, there is an exception to this rule if the taxpayer's child and spouse file a joint return only to claim a refund of income tax withheld or estimated tax paid. In such a case, the return is regarded as a claim for refund rather than a return and the joint return test is still considered satisfied.

**EXAMPLE:** Frank is the 18-year-old married son of Andrew. Frank and his wife earned $800 of wages from part-time jobs and have no other income. The wages do not meet the minimum income threshold for filing a tax return, so neither is required to file a federal income tax return. In order to get a refund of taxes withheld, however, Frank and his spouse file a joint return. In this case the exception to the joint return test applies, so Frank may still be claimed as a dependent on Andrew's return.

**Qualifying Child Criteria**
As indicated above, an individual who meets the citizenship or residency and joint return tests may be claimed as a dependent if they meet the additional criteria as a qualifying child or qualifying relative. We will consider the qualifying child criteria first, which is composed of four elements: relationship, principle place of abode, age, and support.

**Relationship Criteria**
In order to be a qualifying child of the taxpayer, an individual must bear a specified relationship to the taxpayer. Specifically, the individual must be either: (1) a child (natural, adopted, step, or foster) of the taxpayer or a descendant of such a child, or (2) a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative.

A person legally adopted by a taxpayer is considered a child of the taxpayer for all purposes, and is legally indistinguishable from a natural child of the taxpayer. Furthermore, status as an “adopted” child of the taxpayer for qualifying child purposes extends to an individual lawfully placed with the taxpayer for legal adoption, even before the adoption is final. If the adopted individual is a citizen or resident of the United States, the fact that the individual did not reside in the same household for the entire taxable year with the taxpayer is immaterial.

A stepchild is defined as someone who is the child (natural or adopted) of a taxpayer's spouse, but is not otherwise the child of the taxpayer. The status of a person as a stepchild for tax purposes is unclear if the taxpayer divorces the actual parent of the child or the actual parent-spouse predeceases the taxpayer. In a Technical Advice Memorandum (“TAM”), the IRS ruled that a child of a taxpayer's predeceased spouse remained an “applicable family member” of the taxpayer for purposes of the special estate tax valuation rules under Code section 2701. Practitioners should be cautious about relying on this precedent in the context of the dependency exemption, however. First of all, as noted, the TAM addressed an estate tax valuation issue, not the dependency exemption. Furthermore, it is unclear if the same result would have been reached in the case of a divorce or a remarriage after the first spouse's death. Therefore, taxpayers would be better advised to rely on the qualifying relative test rather than the qualifying child test if possible when claiming a dependency deduction for a child who is not the taxpayer's natural, adopted, or foster child, but is rather the child of a former spouse.

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6 TAM 9841005.
To qualify as a foster child, that child must be placed with the taxpayer by an authorized placement agency or by judicial decree or order. Merely caring for the child of someone else as if that child is the taxpayer’s own does not constitute status as a foster child for this purpose.

**EXAMPLE:** Ally’s best friend Susan is hospitalized for an extended period of time. To help out, Ally voluntarily cares for Susan’s two-year-old son Adam, who is not related to Ally. Since Adam is not related to Ally and has not been placed with Ally by a state agency or court order, Adam cannot be the qualifying child of Ally (whether or not Adam could be a dependent of Ally as a qualifying relative depends on other criteria that will be discussed below).

**Principle Place of Abode Criteria**
In addition to meeting the relationship criteria, the individual must reside in the same principal place of abode as the taxpayer for more than one-half of the taxable year to be the taxpayer’s qualifying child. This criterion is determined based on the demonstrable facts and is strictly applied. In other words, coming “close” to having the same principle place of abode for more than half the year does not satisfy this criterion. Furthermore, as with claims to any tax benefits, the burden of proof is on the taxpayer, so if challenged, the taxpayer would be obligated to demonstrate specifically that the child shared their principle place of abode for more than half the tax year.

There are exceptions for temporary absences. For example, an individual is considered to have lived with the taxpayer during any period in which the taxpayer is temporarily absent due to special circumstances such as illness, education, vacation, or military service.

**Age Criteria**
In addition to the relationship and principle place of abode criteria, the individual must meet certain age requirements to be a qualifying child. First, the individual must be younger than the taxpayer seeking to claim the individual as a dependent.

**EXAMPLE:** James is 21 years old and supports his brother Jake, who lives with him for the full year. Jake is 23. Although the relationship and principle place of abode criteria are met, Jake fails the age criteria because he is older than James, and therefore cannot be considered James's qualifying child (whether Jake can be James's dependent as a qualifying relative is based on different criteria discussed below).

Furthermore, in order to be a qualifying child the individual must either be under the age of 19 as of the close of the calendar year or a student and under the age of 24 as of the close of such calendar year. The term “student” for this purpose means an individual who is either: (1) a full-time student at an educational organization, or (2) pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization, state, or political subdivision. To qualify for this status, the individual must have been a student during each of at least five calendar months during the taxpayer’s taxable year.

There is one situation where the age limitations do not apply. If the individual is permanently or totally disabled at any time during the calendar year, he or she will automatically satisfy the age criteria. An individual is permanently and totally disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.
Support Criteria
Finally, in addition to the relationship, principle place of abode, and age criteria, the individual may not provide over one-half of his or her own support for the calendar year in order to be the qualifying child of another person. For this purpose, “support” includes things like food, clothing, housing, recreation, entertainment, vacations, medical and dental care, and child care expenses. Gifts and allowances are considered to be support provided by someone else.

Note that, by its terms, satisfaction of this criterion does not require that the taxpayer claiming the qualifying child as a dependent provide more than one-half of the individual’s support. A taxpayer who provides less than one-half of the support of an individual may still claim that individual as a qualifying child as long as the other criteria are met and more than one-half of the individual’s support comes from a source other than the individual himself or herself.

Scholarships for educational study are not taken into account as “support” for this purpose. Likewise, in the case of a foster child any payment provided by the state government is not considered support coming from the child.

**EXAMPLE:** Robbie provides $3,000 of support for Kim, a foster child of Robbie. In addition, the state provides $4,000 for Kim’s support, but Kim does not provide any of his own support. Although the state actually provides more support to Kim than Robbie, Kim may nonetheless be Robbie’s qualifying child dependent if the other criteria are met because Kim does not provide more than one-half of his own support.

Tie Breaking Rules for Qualifying Child Dependents
Since two or more taxpayers could share a single principle place of abode and thus both have the same principle place of abode as a potential qualifying child for more than one-half the tax year, and because the support test is not necessarily tied to support provided by the taxpayer, it is quite possible that an individual could meet all of the criteria for being a qualifying child of two or more taxpayers. In that circumstance, special tie-breaking rules apply so that the individual may not be claimed as a dependent by more than one taxpayer.

Specifically, if two or more taxpayers may claim an individual as a qualifying child for the same tax year, the individual is treated as the qualifying child of the taxpayer who is a parent of the individual. If neither taxpayer is a parent of the individual, the individual is the qualifying child of the taxpayer with the highest AGI for that tax year.

If both of the taxpayers who otherwise may claim an individual as a qualifying child for the same tax year are parents of the individual and they do not file a joint return, the individual is treated as the qualifying child of the parent with whom the individual resided for the longest period of time during the tax year, or if the child resided with both parents for the same amount of time during the tax year, the parent with the highest AGI. The same rule applies where a child is a qualifying child of both parents who are registered domestic partners.

If an individual’s parents may claim that individual as a qualifying child but no parent does, then another taxpayer may claim the individual as a qualifying child only if that taxpayer’s AGI is higher than the AGI of the parent with the higher AGI.

**EXAMPLE:** Roger and Gertie, a married couple, and Junior (their son) reside together with Granny (Junior’s grandmother) in the same house for the first 8 months of 2016. Junior is 17 years old and does not provide any of his own support. For the last 4 months of 2016, Roger, Gertie, Granny, and Junior each live separately. Roger and Gertie file married-separate returns for 2016, with Roger
reporting an AGI of $55,000 and Gertie having an AGI of $45,000. Under these circumstances, Junior could possibly be the qualifying child of Roger, Gertie, or Granny. Since Roger and Gertie are both parents of Junior and Junior shared a principle place of abode with both for the same amount of time, Junior will be the qualifying child of Roger because he has a higher AGI than Gertie. If neither Roger nor Gertie claims Junior as a dependent, he could be claimed as the qualifying child of Granny only if Granny's AGI exceeded $55,000.

**Issues Related to Divorce or Separated Parents**

When parents of a child are separated or divorced, the parent with physical custody of a child for more than half of the tax year is the parent entitled to claim the dependency exemption with respect to that child. The custodial parent may, however, give up his or her claim to the dependency exemption to the noncustodial parent, provided four requirements are met. First, the qualifying child must have received over one-half of his support during the calendar year from his parents, who are either divorced, legally separated, or have lived apart during the last six months of the calendar year whether or not they were actually married. Second, the qualifying child must have been in custody of one or both parents for more than one-half of the calendar year.

**EXAMPLE:** Don and Elizabeth are the divorced parents of one minor child, Henrietta. Under a custody decree, Henrietta's grandmother has physical custody of her from January 1 to July 31. Because neither Don nor Elizabeth (nor the both of them together) have physical custody of Henrietta for over one-half of the calendar year, she is not a qualifying child of either Don or Elizabeth. Neither Don nor Elizabeth therefore would have any ability to “release” the dependency exemption to the other.

The third requirement is that the custodial parent must sign an unconditional written declaration that he or she will not claim the individual as a dependent. While the release does not necessarily have to be signed using Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*, use of Form 8332 is recommended. It is imperative that the release be *unconditional*. For example, suppose a parent signs a written declaration that he or she will not claim the child as a dependent as long as the other parent is up-to-date with his or her child support obligations. Such a release would be ineffective because of this condition. Furthermore, in most cases the court order specifying which parent is entitled to the dependency exemption for the child will not suffice. State court orders do not supersede the tax requirements, and an order that is not essentially the equivalent of Form 8332 containing all of the requirements contained in that form will not suffice.

A release can be made effective for all future tax years, for only specified tax years (*i.e.*, odd-numbered years), or for a temporary period of time (*i.e.*, one or two tax years). The release must state the name of the noncustodial parent to whom the exemption is released, and the years in which the release is effective. A release that specifies “all future years” is treated as effective in the first taxable year after the taxable year of execution and all following taxable years.

Furthermore, a release can be revoked. A revocation will be effective no earlier than the tax year following the year the custodial parent provides the noncustodial parent with a copy of the revocation or makes a reasonable effort to provide the noncustodial parent with a copy of the revocation. Also, the custodial parent must attach a copy of the revocation to his or her tax return for each year they claim the exemption as a result of the revocation. Taxpayers revoking a release of the dependency exemption must keep a copy of the revocation and evidence of delivery of the notice to the noncustodial parent, or of reasonable efforts to provide actual notice.
EXAMPLE: Tom and Sue are the divorced parents of Ron, and Sue is the custodial parent. In 2012, Sue released a claim to exemption for Ron on Form 8332 for the years 2013 through 2016. In 2014, Sue decided to revoke the previous release of exemption. If Sue completes Part III of Form 8332 and provides a copy of the form to the Tom in 2014, the revocation will be effective for 2015 and 2016. Furthermore, Sue must attach a copy of the revocation to her 2015 and 2016 tax returns and keep evidence of delivery of the notice to Tom.

The fourth, and perhaps most important, requirement is that the noncustodial parent must attach that written declaration to his or her tax return for each year in which the qualifying child is claimed as a dependent. A failure to attach the written declaration, or attaching something that does not satisfy the criteria set forth above, will result in the disallowance of the dependency exemption.

Illustrative Cases

It is crucial that the shifting of dependency deductions away from the custodial parent be unconditional. Carlos Calderon and Tania Daza had been happily married for years, and had three children together. However, in 2009 it became apparent that their marriage was no longer working and they decided to divorce. The couple agreed that Tania would be the custodial parent, and Carlos would pay her child support. Part of the agreement, however, was that Carlos would be allowed to claim the dependency exemptions for their children, provided he pays Tania child support.

After faithfully paying Tania child support, Carlos claimed the deductions for their children on his tax returns. The IRS disallowed the deductions, and Carlos brought the case to Tax Court. How could his entitlement to the dependency exemptions be clearer? The agreement, incorporated into the divorce decree was plain as day. He could prove that he met his obligation to pay child support, so surely the Tax Court would rule in his favor, or so he thought.

However, like so many other taxpayers, Carlos learned that a simple agreement to shift the dependency deduction is not enough. The Tax Court sided with the IRS, stating that in order for Carlos to allowably be able to claim his children as dependents, there must be an unconditional declaration from Tania stating that she will not claim them as dependents. Understandably, Tania did not feel that Carlos should get the benefit of the dependency deductions if he did not pay child support. For that reason, however, the agreement was not unconditional and therefore not effective in transferring the dependency deduction.

Taxpayers must also be mindful of the signature requirement. Unfortunately for Anthony Hendricks and Lisa Williams, their marriage was not working out. As a result, after 10 years of marriage, the couple’s marriage was dissolved in 2007. The court documents concerning their marriage show that the couple carefully thought out the terms and conditions, such as custody, child support, distribution of property, and even who would claim the deductions relating to their two children. The document with the final divorce judgment listed Lisa as the custodial parent, but stated that Anthony and Lisa would each claim one of the children for a dependency deduction on their tax returns. Neither Anthony or Lisa signed this document.

In accordance with their understanding, Anthony claimed one of the children as a dependent on his 2011 tax return. The IRS disallowed this claim, and Anthony appealed to the Tax Court. The Tax Court found for the IRS since the document that gave Anthony the right to claim a dependency deduction was unsigned.

Lastly, the definition of a “qualified child” is crucial. Gregory McBride lived in Massachusetts with his son, daughter, and daughter's children. His son and daughter were both adults.\(^9\) Greg's daughter claimed a dependency exemption deduction for her children. However, due to some sort of miscommunication, Greg also decided to claim dependency exemptions not only for his grandchildren, but children as well. As a result, the IRS disallowed Greg's deductions and Greg petitioned the Tax Court for relief.

The Tax Court found for the IRS, finding that Greg's children and grandchildren were not qualifying children or relatives for purposes of claiming dependency exemption deductions. The court found this about Greg's children since both of them were adults not under the age of 19 or a student and under the age of 24. In addition, his daughter's income was more than double the exemption amount. The court found that Greg was not entitled to exemptions for his grandchildren since there was no evidence that Greg provided half of their support. The Tax Court affirmed that Greg's daughter should get the exemption since his daughter had already filed the exemption, and his grandchildren were considered to be qualifying children of his daughter.

In another case Jim Roberts had a daughter and three grandchildren.\(^10\) In January 2012, the daughter and her children became homeless. One of the children was a newborn and the others were two and four years old, respectively. Jim took the three grandchildren in for 10 months, during which time they lived with him in his apartment and he financially supported them. Jim's daughter also occasionally lived in the apartment and provided nonmonetary care to her children.

Jim claimed dependency exemptions for his three grandchildren on his 2012 tax returns. The IRS disallowed these deductions on the basis that Jim did not demonstrate that he met the principal place of abode and support criteria. Jim petitioned the Tax Court for relief.

The Tax Court sided with Jim, holding that all the qualifying child criteria were met. The court held that by having the grandchildren live with him, the principal place of abode criteria was met. The support criteria had been met since Jim was the sole financial support for the grandchildren. As a result, Jim was entitled to dependency deductions for his three grandchildren.

Finally, consider the case of Leticia Saenz.\(^11\) From January through August of 2011 Leticia Saenz lived with and financially supported her daughter and grandchild. For the remainder of the year, Leticia’s daughter and grandchild lived with her daughter’s boyfriend Michael Nieto. Leticia claimed her daughter and grandchild as dependents. In what was likely a surprise to Leticia, in April 2012 her daughter and Mike filed a joint income tax return where they represented that they were married. Ever the romantic, Mike stated that he agreed to marry Leticia’s daughter when they realized that filing their tax returns jointly would be beneficial.

Despite the lack of clarity to the couple's entitlement to file jointly, the IRS processed the return as a joint return and disallowed Leticia’s dependency claims. The IRS’s position was that the joint return of Mike and Leticia’s daughter prevented her from claiming her daughter and grandchild as dependents. Leticia was having none of that, so she took her case to Tax Court.

The Tax Court held that Leticia was entitled to her dependency exemption deductions since her daughter and grandchild who resided with her for more than half of the year were considered to be her qualifying children. Since the evidence shows that Mike and Leticia’s daughter were not actually married, Leticia could claim her daughter as a qualifying child for the dependency exemption

deduction. Leticia’s daughter was barred from claiming her child as a dependent since Leticia’s daughter was already Leticia’s dependent. Leticia’s grandchild could be a qualifying child under Code section 152 since she (1) was Leticia's grandchild, (2) had the same principal place of abode as her for more than half of 2011, (3) was a minor, (4) did not provide more than half of her own support, and (5) was not married. As a result, Leticia was allowed to claim both her daughter and grandchild for dependency exemptions.

**Qualifying Relative Criteria**

As noted above, a “qualifying dependent” is either a “qualifying child” or a “qualifying relative.” Even if an individual is not a qualifying child, if they meet the citizenship or residency and joint return tests, the individual may be claimed as a dependent if they also meet the additional criteria as a qualifying relative. The qualifying relative criteria are composed of three elements: relationship or member of household, gross income, and support.

**Relationship or Member of Household Criteria**

The individual sought to be claimed as a “qualifying relative” must bear a specified relationship to the taxpayer. The types of allowed relationships are specifically delineated and include, somewhat counter-intuitively, an unrelated person who lives with the taxpayer for the entire tax year. Thus, someone who is not related to the taxpayer in any way can be a “qualifying relative.”

The first group of specified relationships consists of the taxpayer’s direct lineal descendants. This includes the taxpayer's child and any descendant of the child. It also includes the taxpayer's stepchild and eligible foster child. Note that this category overlaps the “qualifying child” definition. Thus, a child who does not meet the qualifying child definition may nonetheless be a dependent under the qualifying relative definition. For example, suppose the taxpayer's 30-year-old son resides with the taxpayer. Because the son exceeds the age threshold, he cannot be treated as a qualifying child, but may be a qualifying relative.

The second relationship group consists of the taxpayer's siblings and any descendants thereof. Thus, this category includes not only the taxpayer’s brother, sister, stepbrother or stepsister, but his or her nieces and nephews as well.

The third group includes the taxpayer’s parents, the parents’ ancestor, and the parents’ siblings. This relationship group includes the taxpayer's stepfather or stepmother as well as aunts and uncles by whole or half blood.

The fourth group includes six types of in-laws. Those six types are: son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. Of special note is the fact that, for purposes of the dependency exemption (unlike for purposes of real life), once any of these relationships are established they are not deemed to be ended by divorce or death. Therefore, the taxpayer may claim his ex-father-in-law as a qualifying relative, even if the taxpayer is divorced (provided the other requirements of qualifying relative are met).

As noted above, the final group included in the classification of qualifying relative seems oxymoronic in that it consists of unrelated persons. Rather than create a third, separate category of dependent, the IRS has decided that an individual who is unrelated to the taxpayer but who had the same principal place of abode as the taxpayer and was a member of the taxpayer’s household during the entire taxable year could be considered a qualifying “relative,” despite the confusion that terminology may create.
**Gross Income Criteria**
The qualifying relative’s gross income for the taxable year must fall below the exemption amount specified under Code section 151(d) for that year. For 2016 the exemption amount is $4,050. Gross income includes all forms of taxable income, including money, property, or services. Excluded, however, are items of tax-exempt income such as social security benefits, exempt veteran’s pension, and expense reimbursement incurred on behalf of an exempt organization.

Gross income does not, however, include certain income of handicapped dependents. This rule applies to an individual who is permanently and totally disabled at any time during the taxable year, and receives income attributable to work performed at a sheltered workshop, if the availability of medical care at the workshop is the principal reason for the individual’s presence and the income arises solely from activities at the workshop that are incident to the medical care. A “sheltered workshop” means a school that provides special instruction or training designed to alleviate the disability and is operated by a 501(c)(3) organization, or by a government entity.

An individual is considered permanently and totally disabled if that individual is “unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.” The individual is not considered disabled unless proof of disability is provided to the IRS at a time and manner prescribed by the regulations.

Gross income also does not include an individual’s scholarship payments from an educational organization, if that individual is a child of the taxpayer and a student. The term “student” means an individual engaged in study during at least five months of the taxpayer’s taxable year (1) as a full-time student at an educational organization, or (2) pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization, state or political subdivision. Scholarship payments may include boarding and lodging furnished by the educational organization.

**Support Criteria**
For the individual to meet the qualifying relative exemption, the taxpayer must furnish more than one-half of the individual’s support for the calendar year. Note the difference between this requirement and the support criteria for determining an individual’s status as a qualifying child. In the latter case, the requirement is that the claimed dependent did not provide over one-half of his or her own support for the calendar year.

**EXAMPLE:** Robbie provides $3,000 of support for Kim, a member of Robbie’s household for the entire year that has gross income below the applicable exemption amount. Kim’s only other source of support is a state welfare program that provides Kim with $4,000. Although Kim does not provide any of her own support, Robbie does not provide more than half of her support, and therefore Kim is not Robbie’s qualifying relative.

To determine whether the taxpayer provided more than one-half of the individual’s total support, such support is compared with the entire amount of support from all sources. Only amounts actually used for the individual’s support are included; funds available to the individual, but not used for support, will not count. This includes the amount of individual’s tax-exempt income.

**EXAMPLE:** Eunis provides $4,000 toward her mother Betty’s support during the taxable year. Assume that during the same taxable year, Betty had earned income of $600, non-taxable social security benefits of $4,800, and tax-exempt interest of $200 and that she used all of these amounts for her own support. In this case Eunis cannot claim a dependency exemption for Betty because the
support provided by Eunis was not more than one-half of her total support of $9,600 ($4,000 + $600 + $4,800 + $200).

Sometimes two or more taxpayers provide support but neither of them satisfies the support criteria individually. In a case where the aggregate support meets the criteria and each taxpayer provides over 10% of such support, the taxpayers must determine which of them will claim the qualifying relative. The taxpayers who do not claim the exemption must sign a statement agreeing not to do so for that year. The statement does not have to be attached to the return, but the taxpayer claiming the exemption must keep them for his or her records.

**EXAMPLE:** Oscar and his siblings provide the entire amount of support of their mother. Oscar provides 45% of this amount, his sister Julie provides 35%, and his two twin brothers Burt and Ernie each provide 10%. None of them satisfies the support test individually, but collectively they do. In order for Oscar to claim his mother as a qualifying relative, Julie, Burt, and Ernie must each sign a statement agreeing not to take a dependency exemption for their mother.

For the qualifying relative exemption, where a parent remarries and the new spouse provides support to a child, such support is treated as having been received from a parent. Generally, this means that support provided by the taxpayer’s spouse is treated as support provided by the taxpayer.

**TAXABILITY OF WAGES, SALARIES, TIPS, AND OTHER EARNINGS**

Gross income includes all income from all sources, whether received in the form of money, goods, property, or services. All transfers of economic benefits are considered income unless specifically exempted under the Internal Revenue Code (“Code”).

The types of economic benefits that are excluded from individual income and the Code sections that exclude them are: certain death benefits (§101); gifts and inheritances (§102); interest on state and local bonds (§103); compensation for injuries or sickness (§104); amounts received under accident and health plans (§105); contributions by employer to accident and health plans (§106); the rental value of parsonages for ministers (§107); income from discharge of indebtedness (§108); improvements by lessee on lessor’s property (§109); qualified lessee construction allowances for short-term leases (§110); recovery of tax benefit items (§111); certain combat zone compensation of members of the armed forces (§112); qualified scholarships (§117); meals or lodging furnished for the convenience of the employer (§119); amounts received under qualified group legal services plans (§120); gain from sale of a principal residence (§121); certain reduced uniformed services retirement pay (§122); amounts received under insurance contracts for certain living expenses (§123); cafeteria plans (§125); certain environmentally-related cost-sharing payments (§126); educational assistance programs (§127); dependent care assistance programs (§129); certain personal injury liability assignments (§130); certain foster care payments (§131); specified fringe benefits (§132); certain military benefits (§134); income from United States savings bonds used to pay higher education tuition and fees (§135); energy conservation subsidies provided by public utilities (§136); adoption assistance programs (§137); Medicare Advantage MSA (§138); disaster relief payments (§139); federal subsidies for prescription drug plans (§139A); benefits provided to volunteer firefighters and emergency medical responders (§139B); COBRA premium assistance (§139C); and Indian health care benefits (§139D).

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12 IRC §561.
EXAMPLE: Joan works for XYZ, which pays her a salary, provides her with health insurance, and allows her to live in an apartment owned by the company without having to pay any rent. The fair rental value of the apartment (i.e., what the company could have received in rent from a paying tenant) is an economic benefit that has been transferred to Joan and is thus taxable income to her. On the other hand, while the health insurance benefits are also an economic benefit transferred to her, Code section 106 specifically excludes employer-provided healthcare coverage from income. Thus the amount XYZ pays for Joan's health insurance is not taxable to her.

In some instances, an economic benefit may be only partially excluded from income. For example, a taxpayer has to include part of his or her social security benefits if they were married, but file a separate return, and lived with their spouse at any time during 2016 or if half of the social security benefits plus other gross income and any tax-exempt interest equals more than $25,000 ($32,000 if married filing jointly).

EXAMPLE: Sam and John both receive social security benefits. Sam is married, but lives with his spouse for only 3 days in 2016 and files a separate return. He has $15,000 of taxable income, social security benefits of $12,000, and tax-exempt interest of $2,000. John is single and earns $35,000 from working as a greeter at a local chain store. Both Sam and John will have to include part of their social security benefits in income. This is true for Sam because he lived with his spouse a portion of 2016 (even though it was only 3 days) and files a separate return. John will have to include a portion of his social security benefits because his income exceeds $25,000 ($35,000 in wages). If Sam filed a joint return with his spouse, he could exclude all of his social security benefits. Likewise, if the total of John's income equaled less than $25,000, he would be able to exclude all of his social security benefits.

There is a special rule for individuals who are married and whose permanent home is in one of the nine “community property” states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin). In these states, any income that qualifies under state law as “community income” is divided equally between the spouses for tax purposes. Note that same-sex couples in a registered domestic partnership in California, Nevada, and Washington are treated as married for this purpose (but not for filing status purposes, as noted below). This is because those states extend community property rules to registered domestic partners but registered domestic partners are not “married” under state law. Therefore, these taxpayers are not married for federal tax purposes. Inclusion of income for federal tax purposes depends on state property law, not state matrimonial law.

EXAMPLE: Jennifer lives in Nevada and does not work, but her registered domestic partner earns $100,000 of income that is considered community income under state property law. Although Jennifer is not considered married for federal tax purposes and will have to file her federal income tax return as single, she will have to include $50,000 of the community income on that return due to state property law principles.

INTEREST AND DIVIDEND INCOME (TAXABLE AND NON-TAXABLE)

Interest Generally

Interest can be defined as the implicit or express amount due to a creditor for the use of the creditor’s money, or for the creditor’s forbearance in demanding repayment, and is generally included as an item of gross income. While municipal bond interest is not taxable for federal income tax purposes, interest on U.S. obligations (such as U.S. Treasury bills, notes, and bonds, issued by
any agency or instrumentality of the United States is taxable for federal income tax purposes, as is interest paid by the taxing agency (whether federal, state, or local) on tax refunds.

Certain distributions commonly referred to as dividends may actually be interest, such as “dividends” from deposits or on share accounts in credit unions, savings and loan associations, and mutual savings banks. These payments can be identified as interest because they will be reported to the recipient on Form 1099-INT rather than Form 1099-DIV. On the other hand, some receipts that might be assumed to be interest are actually dividends. For example, money market funds offered by nonbank financial institutions, such as mutual funds and stock brokerage houses, pay dividends, not interest.

**The OID Rules**

Interest may be paid periodically or may be deferred. While taxpayers generally include interest in income when actually received, if interest is deferred for more than a year the original issue discount (“OID”) rules apply. For example, a taxpayer holding a certificate of deposit (“CD”) with a maturity of more than one year must include in income each year a part of the total interest due and report it in the same manner as other OID.

OID is generally included in income as it accrues over the term of the debt instrument, whether or not the holder receives any payments from the issuer. A debt instrument has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. For example, when a $10,000 bond is issued for $8,000 there is OID, which is defined as the difference between the stated redemption price at maturity and the issue price. In the forgoing example, the stated redemption price is $10,000 and the issue price is $8,000, so OID is $2,000. Zero coupon bonds, which are instruments that pay no interest before maturity, are another example of debt that generates OID.

The OID rules generally do not apply to short-term obligations with a fixed maturity date of one year or less from date of issue. Furthermore, “de minimis” discounts can be ignored when the discount is less than one-quarter of 1% (.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity. In those cases, the difference between the redemption amount received and the price paid at issuance is treated as capital gain.

**EXAMPLE:** Dan buys a 10-year bond with a stated redemption price at maturity of $1,000 from the issuer for $980. As a result, the OID is $20 ($1,000 – $980). One-quarter of 1% of the stated redemption price of $1,000 (.0025 x $1,000 = $2.50) multiplied by the number of full years from the date of original issue to maturity (in this case 10) is $25. Because the $20 discount is less than $25, the OID is ignored. Assuming Dan holds the bond at maturity, he will recognize $20 ($1,000 – $980) of capital gain.

The OID rules do not apply to tax-exempt obligations, such as municipal bonds, nor do they apply to interest on U.S. savings bonds. Furthermore, the OID rules do not apply to loans between individuals if: (1) the lender is not in the business of lending money; (2) the amount of the loan, plus the amount of any outstanding prior loans between the same individuals, is $10,000 or less; and (3) avoiding any federal tax is not one of the principal purposes of the loan.

The issuer of the debt instrument that is subject to the OID rules or brokers holding such instruments on behalf of taxpayers should provide the taxpayer with Form 1099-OID if the total OID for the calendar year is $10 or more. Form 1099-OID will show the amount of OID for the part of the year that the taxpayer held the bond in box 1 and the stated interest that must be included in
income in box 2. However, the OID shown in box 1 must be recalculated if the taxpayer bought the debt instrument after its original issue and paid a premium, or if the debt instrument is a “stripped bond” or a “stripped coupon” instrument (i.e., a bond with respect to which there’s a separation in ownership between the bond and any coupon that has not yet become payable). To determine how to recalculate the OID under these circumstances, consult IRS Publication 1212, Guide to Original Issue Discount (OID) Instruments.

If a taxpayer has OID for the year but did not receive a Form 1099-OID, the preparer can use tables found at www.irs.gov that list total OID on certain debt instruments and have information to assist in figuring the amount of OID. For the latest OID tables, go to www.irs.gov and enter “OID tables” in the search box. If the debt instrument in question is not listed, the preparer should consult the issuer for further information about the accrued OID for the year.

Other Interest Rules

Financial Institution Transactions
If the taxpayer withdraws funds from a deferred interest account (such as a CD) before maturity, a penalty may be imposed. The penalty should be reported to the taxpayer on Form 1099-INT, box 2. The penalty is not netted against the interest income reported on the tax return. Rather, the total amount of income must be reported without subtracting the penalty and the penalty should be separately subtracted from income to arrive at AGI on the Form 1040.

Likewise, interest paid on money borrowed from a bank or savings institution to meet the minimum deposit required for a CD from the institution and the interest earned on the CD are two separate items. The total interest earned must be reported in income. If the taxpayer itemizes deductions, the interest paid may be deducted as investment interest up to the amount of the taxpayer’s net investment income.

EXAMPLE: Adrian deposited $5,000 with a bank and borrowed $5,000 from the bank to make up the $10,000 minimum deposit required to buy a 6-month CD. The CD earned $575 at maturity in 2016, but Adrian receives only $265, representing the $575 interest earned less $310 interest charged on the $5,000 loan. The bank issues a Form 1099-INT for 2016 showing the $575 interest earned. The bank also provides Adrian with a statement showing that $310 interest was paid to the bank for 2016. Adrian must include the $575 in income. Adrian may deduct $310 of interest payments on Schedule A of Form 1040, subject to the net investment income limit.

Gifts that are commonly provided by financial institutions to new customers opening accounts may have to be reported as interest income. For deposits of less than $5,000, gifts or services valued at more than $10 must be reported as interest. For deposits of $5,000 or more, gifts or services valued at more than $20 must be reported as interest.

EXAMPLE: Tim opens a savings account at his local bank and deposits $800. The account earns $20 interest. As an incentive to open the account, Tim received a $15 calculator. The Form 1099-INT Tim receives should show $35 interest for the year. If the calculator was worth only $5, only the $20 in interest paid would be reported on Form 1099-INT.

Interest from Insurance Policies
Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable in the year it is credited to the taxpayer’s account. However, if the taxpayer may only withdraw the interest on some specified date (such as the anniversary date of the policy) the interest is taxable in the year that date occurs. Likewise, any increase in the value of prepaid
insurance premiums, advance premiums, or premium deposit funds is considered interest income if it is applied to the payment of premiums due on insurance policies or made available for withdraw.

**Unstated Interest and Below-Market Loans**

In general, a below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. The Code recharacterizes below-market loans as transactions in which the lender makes a loan to the borrower in exchange for an interest paying note, and then provides the borrower with the funds to pay the interest. The deemed interest payments are treated as actually made for all purposes of the Code and are included as interest income to the lender.

Likewise, payments for the sale of property that are being reported on the installment basis must always contain an interest component. If no interest is stated or the stated interest is inadequate (i.e., below the applicable federal rate at the creation of the obligation), then interest at the applicable federal rate is imputed.

**EXAMPLE:** Jill sells her business for $100,000 payable in two annual installments of $50,000 each, with no interest stated. Assuming Jill does not opt out of installment sale treatment for the transaction, the sales price has to be discounted to the present value of two annual $50,000 payments at the applicable federal rate. The difference is then treated as interest as each payment is received.

**Dividends**

An individual’s “qualified dividend” income is taxed at the same rates that apply to net capital gains. In 2016 taxpayers in the highest marginal bracket of 39.6% will pay a maximum rate of 20% on the qualified dividends. Taxpayers in the 25%, 28%, 33%, or 35% tax brackets will pay a 15% rate on qualified dividends. Taxpayers in the 15% or 10% marginal income tax brackets, however, will not pay tax on qualified dividends.

Note that the amount of investment interest that may be deducted in any tax year by a noncorporate taxpayer is limited to the taxpayer’s “net investment income” for the year. For this purpose, a dividend is treated as investment income only if the taxpayer elects to treat the dividend as not eligible for the reduced rates. Form 4952 is used to make this election.

**EXAMPLE:** Tina is single and is in the 33% tax bracket for 2016. Her income includes $2,000 of interest and $4,000 of dividends, and she has $5,000 of investment interest expense from broker margin accounts. If Tina does not elect to include any of the dividends in investment income for 2016, she can only deduct $2,000 of her 2016 investment interest expense and the $4,000 of dividend income will be taxed at a 15% capital gain rate. If, however, Tina elects to include the $3,000 of dividends in investment income for 2016, she can deduct the entire $5,000 of investment interest, but will have to pay ordinary income tax rates on these dividends.

Qualified dividend income generally includes dividends received from domestic corporations and qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States. Dividends received from a corporation that is
a passive foreign investment company (“PFIC”) in either the taxable year of the distribution or the preceding taxable year are not considered qualified dividends.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date, dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property (i.e., the stock must remain “unhedged” for the same 60-day period).

**SCHEDULE B, PART III FOREIGN ACCOUNTS AND TRUSTS**

Form 1040, Schedule B, Part III, *Foreign Accounts and Trusts*, must be completed if the taxpayer received a distribution from, or was the grantor of, or a transferor to a foreign trust. More specifically, the taxpayer must check the “Yes” box on line 7a if at any time he or she had a financial interest in or signature authority over a financial account located in a foreign country. Note that this question should be answered “Yes” regardless of whether or not the taxpayer is required to file a Financial Crimes Enforcement Network (“FinCEN”) Form 114, *Report of Foreign Bank and Financial Accounts* (“FBAR”). Furthermore, regardless of whether the taxpayer is required to file FinCEN Form 114, he or she may be required to file Form 8938, *Statement of Specified Foreign Financial Assets*. Failure to file Form 8938 may result in penalties and extension of the statute of limitations. Note that FinCEN Form 114 is filed separately from the tax return, while Form 8938 is filed with the tax return.

If the taxpayer has a financial interest in or signature authority over a foreign financial account exceeding certain thresholds, the Bank Secrecy Act may require the taxpayer to report the account yearly to the Department of Treasury by electronically filing an FBAR. The FBAR is filed on a calendar year basis for all taxpayers and must be received by the IRS no later than June 30 following the reporting year.

United States persons are required to file an FBAR if: (1) the United States person had a financial interest in or signature authority over at least one financial account located outside of the United States; and (2) the aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year reported. United States person includes U.S. citizens; U.S. residents; entities, including but not limited to, corporations, partnerships, or limited liability companies, created or organized in the United States or under the laws of the United States; and trusts or estates formed under the laws of the United States.

There are filing exceptions for the following United States persons or foreign financial accounts:

- Certain foreign financial accounts jointly owned by spouses
- United States persons included in a consolidated FBAR
- Correspondent/Nostro accounts
- Foreign financial accounts owned by a governmental entity
- Foreign financial accounts owned by an international financial institution
- Owners and beneficiaries of U.S. IRAs
- Participants in and beneficiaries of tax-qualified retirement plans
- Certain individuals with signature authority over, but no financial interest in, a foreign financial account
• Trust beneficiaries (but only if a U.S. person reports the account on an FBAR filed on behalf of the trust)

• Foreign financial accounts maintained on a United States military banking facility.

A person who holds a foreign financial account may have a reporting obligation even when the account produces no taxable income. The reporting obligation is met by answering questions on a tax return about foreign accounts (for example, the questions about foreign accounts on Form 1040 Schedule B) and by filing an FBAR.

As noted above, the FBAR must be filed electronically through FinCEN's BSA E-Filing System. The FBAR is not filed with a federal tax return. When the IRS grants a filing extension for a taxpayer's income tax return, it does not extend the time to file an FBAR. There is no provision for requesting an extension of time to file an FBAR.

Those required to file an FBAR who fail to properly file a complete and correct FBAR may be subject to a civil penalty not to exceed $10,000 per violation for nonwillful violations that are not due to reasonable cause. For willful violations, the penalty may be the greater of $100,000 or 50 percent of the balance in the account at the time of the violation, for each violation.

For this purpose, a financial account includes, but is not limited to, securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund (that is, a fund that is available to the general public with a regular net asset value determination and regular redemptions).

A financial account is located in a foreign country if the account is physically located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account. Signature authority is the authority of an individual (alone or in conjunction with another individual) to control the disposition of assets held in a foreign financial account by direct communication (whether in writing or otherwise) to the bank or other financial institution that maintains the financial account.

If the taxpayer received a distribution from a foreign trust, he or she must provide additional information with the return. For this purpose, a loan of cash or marketable securities generally is considered to be a distribution. Furthermore, if the taxpayer was the grantor of, or transferor to, a foreign trust, he or she may have to file Form 3520. Like the FBAR, Form 3520 is not attached to the taxpayer's income tax return but is filed separately.

In general, the U.S. owner of a foreign trust is taxed on the income of that trust. A U.S. person is treated as the owner of a foreign trust under the grantor trust rules of Code sections 671-679, which includes someone who transfers assets to a foreign trust which has a U.S. beneficiary of any portion of the trust. Each U.S. owner should receive a Foreign Grantor Trust Owner Statement (Form 3520-A, page 3), which includes information about the foreign trust income they must report.

In general, the U.S. beneficiary of a foreign trust will report their share of foreign trust income to the extent it is not reported by the transferors to the trust under the grantor trust rules. The U.S. beneficiary should receive a Foreign Grantor Trust Beneficiary Statement (Form 3520-A), or a Foreign
Non Grantor Trust Beneficiary Statement which includes information about the taxability of distributions they have received and foreign trust income they must report. Code section 684 requires the recognition of gain on certain transfers of appreciated assets to a foreign trust.

In addition, the special reporting rules regarding foreign trusts apply to a U.S. person who: (1) creates a foreign trust; (2) transfers any money or property to a foreign trust; (3) receives a distribution from a foreign trust; or (4) is treated as the U.S. owner of a foreign trust.

Taxpayers with specified foreign financial assets that exceed certain thresholds must report those assets to the IRS on Form 8938, Statement of Specified Foreign Financial Assets, which is filed with an income tax return. Those foreign financial assets could include foreign accounts reported on an FBAR. The Form 8938 filing requirement is in addition to the FBAR filing requirement. A chart providing a comparison of Form 8938 and FBAR requirements may be accessed on the IRS Foreign Account Tax Compliance Act web page.

On January 9, 2012, the IRS reopened its Offshore Voluntary Disclosure Program following continued interest from taxpayers and tax practitioners after the closure of the 2011 and 2009 programs. This program offers people with unreported taxable income from offshore financial accounts or other foreign assets an opportunity to fulfill their tax and information reporting obligations, including the FBAR. Although the program does not have a closing date, the IRS may end the program at any time.

Furthermore, on September 1, 2012, the IRS implemented new streamlined filing compliance procedures that were available only to non-resident U.S. taxpayers who failed to file required U.S. income tax returns. Taxpayer submissions were subject to different degrees of review based on the amount of tax due and the taxpayer's response to a risk questionnaire.

On June 18, 2014, the IRS announced the expansion of these procedures. The expanded procedures are available to a wider population of U.S. taxpayers living outside the country and, for the first time, certain U.S. taxpayers residing in the United States; reference IR-2014-73. For eligible U.S. taxpayers residing outside the United States, all penalties will be waived. For eligible U.S. taxpayers residing in the United States, the only penalty will be a miscellaneous offshore penalty equal to five percent of the foreign financial assets that gave rise to the tax compliance issue.

Taxpayers who have not filed a required FBAR and are not under a civil examination or a criminal investigation by the IRS, and have not already been contacted by the IRS about a delinquent FBAR, should file any delinquent FBARs according to the FBAR instructions and include a statement explaining why the filing is late. Select a reason for filing late on the cover page of the electronic form or enter a customized explanation using the 'Other' option. If unable to file electronically you may contact FinCEN's Regulatory Helpline at 800-949-2732 or 703-905-3975 (if calling from outside the United States) to determine acceptable alternatives to electronic filing.

The IRS will not impose a penalty for the failure to file the delinquent FBARs if income from the foreign financial accounts reported on the delinquent FBARs is properly reported and taxes are paid on the taxpayer's U.S. tax return, and you have not previously been contacted regarding an income tax examination or a request for delinquent returns for the years for which the delinquent FBARs are submitted.

Tax consequences can apply to the U.S. owners and U.S. beneficiaries of foreign trust, and to the foreign trust itself. There are several situations in which a Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, or a statement with similar information is required to be filed. The most common circumstances are where a U.S. person: (1)
creates or transfers money or property to a foreign trust; (2) receives (directly or indirectly) any distributions from a foreign trust; or (3) receives certain gifts or bequests from foreign entities.

Furthermore, each U.S. person treated as an owner of any portion of a foreign trust under the grantor trust rules is responsible for ensuring that the foreign trust files Form 3520-A, Annual Information Return of Foreign Trust, with a U.S. Owner and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.

**TAXABLE REFUNDS, CREDITS, OR OFFSETS OF STATE AND LOCAL TAXES**

Refunds received with respect to state and local taxes, as well as credits or offsets related thereto, may or may not be taxable for federal income tax purposes. A “credit or offset” is a tax overpayment which, in lieu of being refunded to the taxpayer, is either applied against an existing liability of the taxpayer, or is available for application against a future liability of the taxpayer, or otherwise used or available for use for the taxpayer’s benefit. Taxpayers who receive a refund of state or local taxes will generally receive Form 1099-G indicating the amount of their state or local income tax refund.

The determination of whether or not to include a refund, credit, or offset of state or local taxes in income for federal tax purposes is based on the so-called “tax benefit rule.” Under this rule, if a taxpayer recovers an amount that was previously deducted or credited against tax, the recovery is included in income to the extent that the deduction or credit reduced the tax liability in a previous year. On the other hand, if no tax benefit was derived from a deduction or credit, the recovery does not have to be included in income.

State and local taxes may be deducted (thereby reducing tax liability) only if the taxpayer itemizes deductions on Schedule A. Therefore, the threshold question is whether the taxpayer claimed the amount refunded as an itemized deduction in a previous year. If an individual did not itemize deductions in the year with respect to which the state or local income tax refund was received, no part of the refund is includible in income for the year of receipt.

**EXAMPLE:** John files a 2015 Form 1040 and takes the standard deduction rather than itemizing deductions on Schedule A. During 2016 John receives a $600 refund of his 2015 state income tax, which is duly reported to him on a Form 1099-G. Because his 2015 state income tax was not deducted against his federal tax liability (due to the fact that he did not itemize his deductions on Schedule A), John should not include the state tax refund received in 2016 on his 2016 federal income tax return.

On the other hand, if the taxpayer itemizes and is able to benefit from the full amount of the deduction for state and local taxes, a subsequent refund of those taxes is fully includible in income for federal income tax purposes. Complications arise, however, when the taxpayer's itemized deductions are subject to a limitation.

The itemized deductions of some taxpayers may be subject to an overall limitation known as the “Pease limitation” (discussed more fully below). If a taxpayer was unable to benefit from the full amount of his or her itemized deductions due to the Pease limitation and the taxpayer later recovers all or part of the state or local taxes that appeared as deductions on that return, some of the refund will not be included in income. The portion of the refund that is includible in gross income in the year of receipt equals the difference between: (i) the allowed itemized deductions from the previous year, and (ii) the amount of the itemized deductions that would have been allowed (or the standard deduction, if greater) had the taxpayer not overpaid their state or local taxes.
EXAMPLE: Opel, an unmarried individual, had allowable deductions for 2015 that consisted entirely of $12,000 of state income taxes. Assume that this deduction was reduced by $3,000 (to $9,000) pursuant to the Pease limitation. In 2016, Opel received a $2,000 refund as the result of an overpayment of her 2015 state income taxes. If Opel had paid only $10,000 in state income taxes in 2015 (and thus not received a refund), her itemized deductions would have been only $7,000. Since Opel received a tax benefit attributable to the full amount of the refund ($9,000 − $7,000 = $2,000), the refund is fully includible in gross income in 2016.

UNEMPLOYMENT COMPENSATION
Any unemployment compensation received must be included in the taxpayer’s income. Furthermore, if the taxpayer received unemployment compensation, he or she may be required to make quarterly estimated tax payments. However, the taxpayer can instead choose to have federal income tax withheld. If the taxpayer received unemployment compensation during the year, they should receive Form 1099-G, showing the amount paid.

Unemployment compensation generally includes any amounts received under the unemployment compensation laws of the United States or of a state. It includes state unemployment insurance benefits and benefits paid to the taxpayer by a state or the District of Columbia from the Federal Unemployment Trust Fund. It also includes railroad unemployment compensation benefits, but not worker’s compensation.

Supplemental unemployment benefits received from a company financed fund are not considered unemployment compensation for this purpose. These benefits are fully taxable as wages, and are reported on Form W-2, Wage and Tax Statement.

Unemployment benefits from a private fund to which the taxpayer voluntarily contributes are taxable only if the amount he or she receives is more than their total payments into the fund. This taxable amount is not unemployment compensation; it is reported as other income on Form 1040, Individual Income Tax Return.

SELF-EMPLOYMENT INCOME (SCHEDULE C-EZ) AND EXPENSES
Income from self-employment is reported on Schedule C or Form 1040. In general, self-employment income includes any non-wage income received from a continuous, regular activity engaged in with a profit motive, including income from rents and bartering. Taxpayers report both the gross income earned from self-employment and deductions allowable against self-employment income on Schedule C.

Deductible Business Expenses
To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary. By definition, business expenses do not include the cost of goods sold, amounts paid for capital items, and costs that are personal in nature.

Cost of goods sold is deducted from gross receipts to figure gross profit for the year. Costs of goods sold may include the cost of products or raw materials used to manufacture goods, freight, storage, direct labor costs (including contributions to pensions or annuity plans) for workers who produce the products, and overhead related to the production process (i.e., utilities related to the manufacturing plant). Any costs included in cost of goods sold cannot be deducted again as
business expenses. Inventory must be valued at the beginning and end of each tax year to determine the cost of goods sold.

There are, in general, three types of costs that must be capitalized: (1) business start-up costs; (2) business assets; and (3) improvements. A taxpayer may elect a limited deduction of up to $5,000 for start-up expenses paid or incurred to acquire or to create a new active trade or business. This amount does not include expenses incurred in connection with the expansion of an existing trade or business. The taxpayer is deemed to have made the election unless he or she opts out. The remainder of business start-up expenses, if any, are capitalized and allowed as a deduction ratably over a 180-month period beginning with the month in which the active trade or business begins.

Costs to improve, restore, or adapt a unit of property to a new or different use must be capitalized. Materials and supplies used to improve a unit of property are generally deductible in the year they are used or consumed in the taxpayer's business operations. Materials and supplies acquired for use in business operations are generally expensed rather than capitalized. The regulations define the term “materials and supplies” as any component acquired to maintain, repair, or improve a unit of property that is not itself part of the unit of property, and any unit of property, including fuel, lubricants, and water, with an economic useful life of twelve months or less.13

Finally, a taxpayer cannot deduct personal, living, or family expenses on Schedule C. However, expenses that are partly for business and partly for personal purposes may be deductible in part. Specifically, the portion of the expense that is directly related to business may be deducted.

**EXAMPLE:** Harry takes out a loan in the amount of $10,000, using $7,000 for his business and $3,000 for a family vacation. Harry may include on Schedule C a business deduction equal to the interest on $7,000 of the indebtedness. Interest on the remaining $3,000 of the loan is a personal expense and not deductible against self-employment income.

**Deduction Related to Business Use of Home**

A deduction is allowable for business use of the taxpayer's home under three circumstances. First, a taxpayer may deduct costs allocable to a portion of his or her home or a separate structure not attached to the home if the portion or separate structure is used “exclusively” and on a regular basis in connection with the taxpayer's business. “Exclusively” for this purpose means that the taxpayer must use the portion of the home or separate structure *solely* for the purpose of carrying on his or her trade or business. If that portion or separate structure is used for both business and personal purposes, no deductions related to the structure are allowed against self-employment income. Furthermore, expenses attributable to the exclusive but incidental or occasional trade or business use are not allowed because the use must be on a “regular” basis for business purposes.

**EXAMPLE:** Frances uses a spare room in her apartment to conduct her self-employment trade or business. Once a month she also uses the room to review her personal finances and pay personal bills. Carl has a separate room in his home that he uses for approximately four hours during the course of the year to prepare an annual budget for his self-employment activities and uses the room for nothing else. Neither Frances nor Carl is entitled to any Schedule C business deduction related to the business use of these spare rooms: Frances because her use is not exclusive and Carl because his use is not regular.

13 Reg. section 1.162-3(c)(1)(ii) and (iii).
The second circumstance in which a deduction is allowable for business use of the taxpayer’s home is to the extent there is space in the residence that the taxpayer uses on a regular basis to store inventory or product samples in connection with his or her business of selling products at retail or wholesale. However, to take a deduction on this basis, the residence must be the sole fixed location of the trade or business.

Third, a deduction is allowable for business use of the taxpayer’s home if the residence is used regularly to provide day-care services for compensation to children, handicapped individuals, or persons aged 65 years or older. If there is only part-time use of a portion of the residence for this purpose, allocation must be made first on the basis of the proportion of total space used to furnish services and then on the basis of the amount of time that space is used for those services compared to the total time the space is available for all uses. The deduction is allowed only if the day-care services are not primarily educational and comply with any applicable state licensing, certification, or approval requirements.

**Automobile Expenses**

A taxpayer can deduct car expenses if they use their car for business purposes. These deductions may include the actual expenses of operating and maintaining a car used for business purposes or a specified amount per business mile driven. Thus, a taxpayer may use the actual cost method or the standard mileage rate. Under the actual cost method, taxpayers may deduct the actual costs of operating a motor vehicle, including depreciation, licenses, gas, oil, tolls, lease payments, insurance, garage rent, parking fees, registration fees, repairs, tires, and car washes.

The standard mileage rate for deductible transportation expenses paid or incurred during 2016 for business is 54 cents per mile. Taxpayers can use this standard mileage rate in computing the deductible costs of operating for business purposes automobiles (including vans, pickups or panel trucks) they own or lease. However, the standard mileage rate cannot be used to compute the deductible costs of an automobile for which the taxpayer:

1. Claimed depreciation using a method other than straight-line for the automobile's estimated useful life;
2. Used the Modified Accelerated Cost Recovery System ("MACRS") or Accelerated Cost Recovery System ("ACRS") under Code section 168;
3. Claimed a Code section 179 deduction; or
4. Claimed the additional depreciation allowance ("bonus depreciation").

Furthermore, a taxpayer can only use the standard mileage rate in computing the deductible costs of operating up to four automobiles that are used simultaneously for business purposes; if the taxpayer uses five or more automobiles for business, the standard mileage rate method is not available.

Note that automobiles are “listed property,” which means that expenses related to them are not deductible unless they are strictly substantiated. As such, it is not only the cost of operating the automobile that must be substantiated, but the amount and date of each use, total use during the relevant tax period, and the business purpose of each use. Use of the standard mileage rate does not relieve the taxpayer of the requirement to substantiate the amount of each business use (that is, the mileage), or the time and business purpose of each use.
It is imperative therefore that the taxpayer keep accurate documentation of the specific business use. The best documentation is a mileage log showing the beginning and ending mileage for each business trip and a description of the business purpose of the trip. If the taxpayer uses his or her car for both business and personal purposes, the expenses must be divided based on actual mileage.

**Travel Expenses**

In general, daily transportation expenses incurred in traveling between a taxpayer’s residence and his or her work location are nondeductible commuting expenses. However, there are three sets of circumstances in which those expenses are deductible:

1. A taxpayer may deduct daily transportation expenses incurred in going between his or her residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works;

2. If a taxpayer has one or more regular work locations away from his or her residence, the taxpayer may deduct daily transportation expenses incurred in going between the residence and a temporary work location in the same trade or business, regardless of the distance; and

3. If a taxpayer’s residence is his or her principal place of business, the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is regular or temporary and regardless of the distance.

In *Curphey v. Commissioner*, the Tax Court held that daily transportation expenses incurred in going between an office in a taxpayer’s residence and other work locations were deductible where the home office was the taxpayer’s principal place of business. The court stated that “[w]e see no reason why the rule that local transportation expenses incurred in travel between one business location and another are deductible should not be equally applicable *where the taxpayer’s principal place of business with respect to the activities involved is his residence*. As has been noted by the IRS itself, implicit in the court’s analysis in *Curphey* is that the deductibility of daily transportation expenses is determined on a business by business basis.

In determining whether daily transportation expenses incurred in going to and from a place of business located at the taxpayer’s residence are more properly treated as personal commuting expenses or as ordinary and necessary business expenses, great weight must be given to the inherently personal character of a taxpayer’s residence and trips to and from that residence. If an office in the taxpayer’s residence satisfies the principal place of business requirements of Code section 280A(c)(1)(A), then the business activity there is deemed to be so central to the taxpayer’s business as to overcome the inherently personal nature of the residence and the daily transportation expenses incurred in going between the residence and other work locations in the same trade or business. If an office in the taxpayer’s residence does not satisfy the principal place of business requirements of section 280A(c)(1)(A), then the business activity there (if any) is not sufficient to overcome the inherently personal nature of the residence and the daily transportation expenses incurred in going between the residence and other regular work locations.

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14 73 T.C. 766 (1980).
15 73 T.C. at 777-78 (emphasis in original).
Other Business Deductions Related to Self-Employment

Other types of business expenses include payments made to others, whether employees or independent contractors, for services related to the business, rent expenses, state and local taxes and licenses attributable to the business, and insurance. The following is a list of some of the more common expenses for which a self-employed person may take a business deduction. This is not designed to be a comprehensive list, and the actual deductibility of any expense listed below depends on its being ordinary and necessary to the business activity and adequately documented:

- Books, trade journals, newspapers and publications for the taxpayer's trade or profession;
- Dues to a professional organization related to the taxpayer's profession;
- Regulatory fees;
- Dues to chambers of commerce and similar organizations if the membership helps the taxpayer generate business;
- Equipment and supplies, including computer, telephone, and copying equipment;
- Internet fees
- Advertising in phone directories and elsewhere;
- Legal and accounting fees;
- One-half of meals and entertainment costs related to the conduct of business
- Separate business telephone (home phone line is not deductible);
- Traveling costs incurred while away from home on business
- Transportation from one job to another if the taxpayer works at two or more locations in one day;
- Specialized clothing designed for your job, as long as it's not suitable for everyday wear
- Safety equipment, such as hard hats, safety glasses, safety boots, and gloves
- Business gifts (but only up to $25 per recipient)
- Postage
- Office supplies
- Interest on business loans
- Repairs and maintenance

Hobby Loss Rules

Code section 183 treats activities that are not pursued for-profit as “hobbies,” and distinguishes deductions related to those activities from deductions for business expenses. Code section 183 only allows loss deductions for hobbies up to the amount of any income from the hobby.

The Code directs the IRS and the courts to presume that an activity is engaged in for profit if the gross income from the activity exceeds the deductions for the activity (i.e., there is profit) for three or more of the immediately preceding five years. This is merely a presumption, not a conclusive determination. That means that when the presumption applies, the burden shifts to the IRS to
demonstrate by a preponderance of evidence that the activity is not being conducted for the purpose of making a profit. The presumption of the taxpayer’s intent to make a profit can be defeated by the IRS if it offers credible evidence that the taxpayer’s activity is only a hobby. Perhaps even more important, the presumption works in one direction only. There is no presumption that the activity is not engaged in for profit if the taxpayer does not show a profit for three years out of five consecutive years. Instead, the general rule applies and the taxpayer retains the burden of showing that a profit motive exists.

The regulations contain nine factors to help discern whether an activity is intended to be profitable. None of these factors is more important than any other factor, and the final decision about a taxpayer’s intent is not automatically made by a majority of the factors being met. Rather, the totality of the facts and circumstances must be considered in light of these factors. Each of the nine factors is briefly discussed below.

**Manner in Which the Taxpayer Carries on the Activity**

This factor looks at three separate questions. The first question is whether the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records. These records should include preparing “any business or profit plans, profit or loss statements, balance sheets, or financial break-even analyses” for the activity. Maintaining such records tends to indicate that the activity is engaged in for-profit.

The second question addressed by this factor is whether the taxpayer conducted the activity in a manner substantially similar to those of other comparable activities that were profitable. Indicators include advertising, the development of a written business plan and having a plausible strategy for earning a profit. The third question is whether the taxpayer changed operating procedures, adopted new techniques or abandoned unprofitable methods in a manner consistent with intent to improve profitability.

**Expertise of the Taxpayer or Advisors**

The IRS and the courts will look to see whether the taxpayer has prepared for the activity by extensive study of accepted business, economic and scientific practices, or consulted with those who are expert in business practice. A taxpayer’s extensive study of the accepted business and economic practices of an activity, as well as the taxpayer’s consultation with experts, may indicate a profit objective. Activities of this nature tend to indicate that the taxpayer has a profit motive demonstrated by a desire to carry on the activity following established and accepted practices.

Note that, if a taxpayer undertakes such preparation or receives expert advice, but does not carry on the activity through accepted business practices, it does not necessarily indicate a lack of intent to make a profit. These circumstances may instead indicate that the taxpayer is trying to develop new or better techniques that may create profits from the activity.

**Time and Effort Expended by the Taxpayer in Carrying on the Activity**

The third factor involves the amount of personal time and effort the taxpayer puts into carrying on the activity. It stands to reason that the more time the taxpayer devotes to the activity, the more likely it is that profit is the motive.

An important factor that is often looked to is whether the taxpayer leaves his job to devote a majority of energy to the activity. While this may be indicative of a profit motive, it is not dispositive.
On the other hand, the fact that the taxpayer devotes a limited amount of time to the activity does not necessarily indicate that the taxpayer does not have a profit motive if the taxpayer employs competent and qualified people to carry on the activity.

**Expectation that Assets Used in the Activity May Appreciate in Value**

The term “profit” encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity, together with the appreciation of land, will exceed expenses of operation. When property’s appreciation in value is independent of the claimed business activity, however, the gain realized from a sale of the property will not be a significant factor in evaluating the nature of the activity in question.

**Taxpayer’s Success in Carrying on Other Similar or Dissimilar Activities**

The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that the taxpayer is engaged in the present activity for-profit, even though the activity is presently unprofitable.

**Taxpayer’s History of Income or Losses with Respect to the Activity**

A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for-profit. Start-up enterprises commonly experience losses in their early years. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status, such continued losses, may be indicative that the activity is not being engaged in for-profit.

If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions or depressed market conditions, such losses would not be an indication that the activity is not engaged in for-profit. To the contrary, of course, a series of years in which net income was realized would be strong evidence that the activity is engaged in for-profit.

It must be noted that the objective must be to realize a profit on the entire aggregate operation. In other words, future net earnings must be sufficient to recoup losses that have been incurred in the earlier years. Thus, exceedingly large losses during the start-up phase may negate the fact that modest profits are reasonably expected in the future.

**Profits Actually Earned and Possibility of Ultimate Profit**

The mere fact that a profit has been generated by an activity is not conclusive as to its status as a for-profit endeavor. The amount of profits has to be considered in relation to the amount of losses incurred, and in relation to the amount of the taxpayer’s investment and the value of the assets used in the activity. An occasional or small profit from an activity that normally generates large losses, or from an activity in which the taxpayer has made a large investment, may not be determinative that the activity is engaged in for-profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for-profit, especially where the investment or losses are comparatively small.
Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for-profit even though losses or only occasional small profits are actually generated. Remember that it is the intent of the taxpayer to make a profit that is at issue, not necessarily the expectations that a reasonable person may have with respect to the activity. The expectation of making a profit does not need to be reasonable.

**Taxpayer’s Financial Status**

Substantial income from sources other than the activity, especially if the losses from the activity produce substantial tax benefits, may indicate that the activity is not engaged in for-profit. This is even more likely to be the case if there are personal or recreational elements involved. On the other hand, the lack of any recreational element may counteract the fact that the taxpayer has substantial outside resources. A taxpayer who has substantial income that is unrelated to an activity can more easily afford to operate the activity as a hobby, possibly indicative of the taxpayer’s lack of a profit motive.

**Elements of Personal Pleasure or Recreation**

Evidence that an activity is carried on for personal pleasure tends to contradict the taxpayer’s assertion that the intent is to make a profit. On the other hand, a profit motive is indicated when an activity has no appeal other than profit.

A taxpayer does not have to pursue an activity with the exclusive intent of obtaining a profit in order for the activity to be considered as engaged in for profit. For example, a taxpayer may pursue an investment strategy influenced by environmental or other concerns. The availability of other investments that could yield a higher return, or that are more likely to be profitable, does not necessarily indicate that an activity is not engaged in for-profit.

The fact that a taxpayer receives personal pleasure from engaging in an activity is not enough to consider the activity to be not for-profit if the activity also meets the factors of this test. A business will not be turned into a hobby simply because the owner finds it pleasurable; suffering has never been made a prerequisite to deductibility.

**REPORTING AND TAXABILITY OF SOCIAL SECURITY BENEFITS**

A taxpayer whose modified AGI plus one-half of the social security benefits received (including Tier 1 Railroad Retirement benefits) for a tax year exceeds either of two threshold amounts is taxed on a portion of social security benefits received that year. “Modified AGI” for this purpose means AGI increased by the amount of tax-exempt interest received or accrued by taxpayer during the tax year and determined without regard to: the social security benefits; the deduction for qualified education loan interest; the deduction for higher education expenses; the exclusions for foreign earned income and housing costs; savings bond proceeds for education expenses; employer-provided adoption assistance; and income from sources within U.S. possessions and Puerto Rico.

A “base amount” is used in determining the taxability of social security benefits under the first threshold. This base amount is $32,000 for individuals filing married-joint returns; zero for individuals filing married-separate returns; and $25,000 for all other individuals. If modified AGI plus one half of the social security benefits received exceeds the applicable base amount, the taxpayer must include in gross income the lesser of: (1) 50% of the social security benefits received that year or (2) 50% of the excess of modified AGI plus one half of the social security benefits received over the base amount.
EXAMPLE: Gertrude and Gary receive social security benefits of $10,000. They file a married-joint return which includes modified AGI consisting of pension income of $22,000. The sum of their modified AGI plus one-half of the social security benefits received ($22,000 + $5,000) is $27,000. Since this is less than their base amount of $32,000, no part of the social security benefits is taxable.

An “adjusted base amount” is used in determining the taxability of social security benefits under the second threshold. The adjusted base amount is $44,000 for married individuals filing jointly; zero for a married individual filing separately; and $34,000 for all other individuals.

If modified AGI plus one half of the social security benefits received exceeds the applicable adjusted base amount, the taxpayer must include in gross income the lesser of: (1) 85% of the social security benefits received that year; or (2) the sum of: (a) the amount included under the first threshold rule or, if less, one-half of the difference between taxpayer's adjusted base amount and base amount, plus (b) 85% of the excess of modified AGI plus one half of the social security benefits received over the “adjusted base amount.”

Finally, if any portion of a lump-sum social security benefit received during a tax year is attributable to an earlier year, the taxpayer can elect (by writing “LSE” on the return) to include in gross income with respect to that portion the sum of the increases in gross income that would have resulted had the portion been paid earlier in the earlier.

CAPITAL GAINS AND LOSSES (SCHEDULE D AND FORM 8949)

Capital Gains Rates

For the 2016 tax year, taxpayers in the highest marginal bracket of 39.6% will pay a maximum rate of 20% on the “adjusted net capital gains.” Taxpayers in the 25%, 28%, 33%, or 35% tax brackets pay a 15% capital gains rate. Taxpayers in the 15% or 10% marginal income tax brackets will not pay any tax on adjusted net capital gains. “Adjusted net capital gains” means net capital gain reduced (but not below zero) by the sum of: (1) the 28% rate gain and (2) the unrecaptured section 1250 gain. Also, the net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under Code section 163(d). The “28% rate gain” refers to the excess of: (1) the sum of the (a) amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles and (b) the additional amount of gain that would be excluded from gross income from the sale of small business stock under Code section 1202 if the percentage limitations of section 1202(a) did not apply, over (2) the sum of (a) the net short-term capital loss for the taxable year and (b) any long-term capital loss carryover to the taxable year.

“Unrecaptured section 1250 gain” means any long-term capital gain from the sale or exchange of depreciable real estate held more than one year (to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation), reduced by the net loss (if any) attributable to the items taken into account in computing 28% rate gain. If the taxpayer also has gain related to Code section 1231 property used in a trade or business, the unrecaptured section 1250 gain is limited to the net section 1231 gain for the year.

An individual's unrecaptured section 1250 gain is taxed at a maximum rate of 25%, and the 28% rate gain is taxed at a maximum rate of 28%. As with other capital gains, taxpayers in the 15% or 10% marginal income tax brackets will pay tax on unrecaptured section 1250 gain and 28% rate gain at their marginal rate.
Note that gains from the sale of inherited capital assets are automatically long-term. By election, long-term capital gains can be used to increase the amount of investment income when figuring the investment interest deduction, but then such gains are not eligible for the lower capital gain tax rates. Although capital losses offset capital gains generally, keep in mind that losses from selling personal-use capital assets, such as a home or automobile, are not deductible and cannot be used to offset gains.

**General Reporting Requirements**

Brokers are required to provide taxpayers (and file with the IRS) Form 1099-B to report the gross proceeds from the sale of stocks, bonds, mutual funds, T-Bills (if sold before maturity) and certain commodities. With respect to so-called “covered securities,” brokers must also include on Form 1099-B the taxpayer’s adjusted basis in such securities sold and disclose whether any respective gains or losses are long-term or short-term. To accomplish this, Form 1099-B includes boxes in which the broker must indicate the date of acquisition, stock or security symbol, quantity of shares sold, cost or other basis, amount of loss disallowed due to wash sales, whether the property sold is a covered or noncovered security and whether the gain or loss is short or long-term.

Generally, “covered securities” include any “specified security” acquired on or after the “applicable date,” but only if the security was either (i) acquired through a transaction in the account in which the security was held; or (ii) transferred to that account from an account in which the security was a covered security, but only if the broker receiving custody of the security receives a statement from the predecessor broker with respect to the transfer. For this purpose, the Code requires a broker transferring a covered security to another broker to furnish the new broker with a written statement regarding the adjusted basis of such securities not later than 15 days after the date of the transfer. A transfer statement must also be provided with respect to securities received through inheritance or gift. Estate executors must provide to estate beneficiaries a transfer statement that includes the decedent’s date of death and the description, basis, and the executor’s valuation for the security(ies) transferred. Those making a gift of a security must provide a transfer statement to the gift recipient disclosing the donor’s purchase date and basis in the security(ies) transferred.

The term “specified security” means (i) any share of stock in a corporation; (ii) any note, bond, debenture, or other evidence of indebtedness; (iii) any commodity or contract or derivative with respect to such commodity, if the IRS deems basis reporting is appropriate; and (iv) any other financial instrument deemed appropriate by the IRS.

The “applicable date” depends on the type of specified security that is purchased. For corporate stock (other than stock in a mutual fund or stock acquired in connection with a dividend reinvestment plan), the applicable date was January 1, 2011. For stock in a mutual fund or stock acquired in connection with a dividend reinvestment plan, the applicable date was January 1, 2012. For debt securities and options the applicable date was January 1, 2014.

**EXAMPLE:** Through his broker, Sam purchased 100 shares of corporate stock, 300 shares of a mutual fund, and $10,000 in face amount of debt securities on June 30, 2012. He instructs his broker to sell each of these investments on November 1, 2014. On the Form 1099-B that the broker issues with respect to these sales, the broker must report Sam’s adjusted basis in the corporate stock and the mutual fund shares and disclose whether any gains or losses with respect thereto are long-term or short-term. Only the gross proceeds from the sale of the debt securities has to be reported, however (not the adjusted basis or whether the gain or loss is long-term or short-term), because those securities were not acquired after the applicable date of January 1, 2014.
If a taxpayer has acquired securities on different dates or at different prices and sells less than the entire position in the security, the broker reports the sale according to the taxpayer's adequate and timely identification of the security to be sold. If no identification is provided, the sale is reported in the following order: first, any shares for which the acquisition date is unknown; then the shares that were acquired first, whether they are covered or noncovered securities. Standing orders may also be used for basis determination.

If a taxpayer leaves shares with a custodian or agent in an account and acquires identical shares of stock at different prices in the account, the so-called “average basis” method is available for stock in most mutual funds or other regulated investment companies and stock acquired after 2010 in connection with a dividend reinvestment plan. Mutual fund shares acquired before January 1, 2012, are treated as held in a separate account from mutual shares acquired on or after that date. A mutual fund may, however, elect on a stockholder by stockholder basis to treat all mutual fund shares held by the stockholder as one account without regard to when the stock was acquired (single account election). When this election applies, the average basis of a customer's stock is computed by averaging the basis of shares of identical stock acquired before, on, and after January 1, 2012, and all the shares are treated as covered securities.

With respect to reporting, Schedules D and D-1 have largely been replaced by Form 8949 for detailed reporting of short and long term capital gain or loss transactions. Form 8949 is also used to report the sale or exchange of capital assets not reported on other forms or schedules (e.g., Form 4797); gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit; and nonbusiness bad debts.

Separate Forms 8949 are used to report three different classes of transactions: (1) transactions reported on Form 1099-B that indicates the basis of the securities transferred; (2) transactions reported on Form 1099-B without any indication of the basis of the securities transferred; and (3) transactions for which the taxpayer does not receive a Form 1099. Each individual security sale during the year must be separately reported on Form 8949. When there are statements from more than one broker or more than one account with the same broker, the taxpayer should report the totals from each broker or account on a separate line of Form 8949.

Schedule D is still used to report:

1. The overall gain or loss from transactions reported on Form 8949;
2. Gains from Form 2439 or 6252 or Part I of Form 4797;
3. Gains or losses from Form 4684, 6781, or 8824;
4. Gains or losses from a partnership, S corporation, estate or trust;
5. Capital gain distributions not reported directly on Form 1040; and
6. Capital loss carryovers from prior years.

**Wash Sales**

Wash sales are defined as a transfer of stock or securities at a loss when, within the 30 days before or after the sale, the taxpayer acquires substantially identical stock or securities or a contract or option to buy substantially identical stock or securities. Losses from sales or trades of stock in a wash sale may not be deducted. Instead, disallowed wash sale losses are added to the cost basis of
the acquired stock or securities. The holding period of the new stock begins on the same day as the
holding period of the stock sold.

**EXAMPLE:** Jollette buys 500 shares of ABC Corp. for $10,000. On December 15, 2016 she sells all of
these shares for $7,000. On January 10, 2017 she buys another 500 shares of ABC Corp. for $8,000.
Because she acquired substantially identical stock within 30 days of the sale, the loss on the sale is
disallowed under the wash sale rules and is instead added to her basis, resulting in a basis of
$11,000 in the stock acquired on January 10 ($8,000 cost + $3,000 disallowed loss). Note also that
only the sale (and not the later acquisition) will be reflected on Jollette's 2016 year-end brokerage
statement. For this reason, preparers should be careful to check subsequent statements when there
is a sale for a loss near year-end.

Note that wash sales include transactions in traditional and Roth IRAs as well. This means that when
an individual sells stocks or securities at a loss and causes his or her IRA or Roth IRA to purchase
substantially identical stocks or securities within 30 days before or after the sale, the loss is
disallowed under the wash sale rules. Under these circumstances, the individual's basis in the IRA or
Roth IRA is not increased.

**PENSIONS, ANNUITIES AND INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)**

**Penalties for Early Withdrawal**

Taxpayers can take distributions from their IRAs (including SEP-IRAs and SIMPLE-IRAs) at any time.
There is no need to show a hardship to take a distribution. However, the distribution is includible in
taxable income and may be subject to a 10% additional tax if the taxpayer is under age 59½. The
additional tax is 25% if the taxpayer takes a distribution from his or her SIMPLE-IRA in the first 2
years they participate in the SIMPLE IRA plan. There is no hardship exception to these additional
taxes.

Required minimum distributions ("RMDs") must be taken from a traditional IRA each year beginning
with the year the taxpayer turns 70½. The RMD for each year is calculated by dividing the IRA
account balance as of December 31 of the prior year by the applicable distribution period or life
expectancy. The RMD requirements do not apply to Roth IRAs.

In general, distributions from a traditional IRA or qualified plan are taxable in the year the taxpayer
receives them. Distributions are made from a designated Roth account, however, are not included in
gross income. A qualified distribution is generally a distribution that is: (1) made after a period of
participation of 5 or more tax years and (2) made on or after the date the taxpayer reaches age 59½,
made to a beneficiary of the taxpayer's estate on or after the taxpayer's death, or made on account
of the disability of the taxpayer.

Taxpayers typically have not made any contributions to traditional pension or defined benefit plans
and therefore distributions from these plans are almost always fully taxable. A distribution will be
only partially taxable, however, if the taxpayer has an unrecovered basis in the traditional IRA or
defined contribution plan when the distribution is made. If only deductible contributions were made
to the taxpayer's traditional IRA or defined contribution plan, then he or she has no basis to recover
and any distributions are fully taxable when received. If, on the other hand, nondeductible (i.e., after-
tax) contributions were made or rolled over to a traditional IRA or defined contribution plan, there is
a cost basis or investment in the contract equal to the amount of those contributions. Those
nondeductible contributions are not taxed when they are distributed to the taxpayer but rather are
a nontaxable return of the taxpayer's investment.
Retirement plan and annuity payments (including military retirement pay) should be reported to the taxpayer on Form 1099-R. Generally, the amount of tax on a distribution from an IRA or qualified plan is determined under the Code section 72 annuity rules. Under these rules, a portion of the distribution is excluded from income based on the amount (if any) of the taxpayer's after-tax contributions to the plan. Specifically, the pro rata amount of each payment received that represents a return of the taxpayer's investment in the contract is excludable.

Two methods are permissible for determining the taxable portion of the distribution under these rules. The first is called the “simplified method” and must be used by taxpayers if the distribution is made under a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity plan or contract and either the taxpayer is under 75 when distributions begin or the taxpayer is entitled to less than five years of guaranteed payments. The simplified method is not available for distributions from a nonqualified plan. The taxability of distributions from a nonqualified plan is determined under what is known as the “general rule.”

Under the simplified method, the tax-free part of each annuity payment is determined by dividing the taxpayer's cost (i.e., aggregate after-tax contributions) by the total number of anticipated monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract. Once the taxpayer's cost is known, preparers can use a worksheet provided in IRS Publication 575 (Worksheet A) to determine the taxable amount.

Under the general rule, the tax-free part of each distribution is determined based on the ratio of the cost of the contract to the total “expected return.” Expected return is the total amount the taxpayer and other eligible annuitants (e.g., a surviving spouse or other beneficiary) can expect to receive under the contract. To figure the taxable amount, life expectancy (actuarial) tables prescribed by the IRS must be used.

Benefits distributed from an IRA or qualified retirement plan are generally taxable to the participant or beneficiary who is entitled to the distribution. For example, a taxpayer, not his ex-wife, was deemed to be the taxable recipient of pension benefits even though his divorce decree contained a provision that required him to pay his ex-wife a monthly amount from his pension plan “if, as, and when” he received a payment from the plan. However, a participant's spouse or former spouse (including a spouse from a valid same-sex marriage) is taxable on any distribution that is made to the spouse (or former spouse) as an “alternate payee” under a qualified domestic relations order ("QDRO").

**IRA Rollover per Year Limit**

Generally, a distribution from an IRA or a qualified plan is includible in gross income. There are important exceptions to this rule regarding “rollovers.” An IRA rollover is defined as a distribution from the IRA to the taxpayer that is subsequently re-deposited by the taxpayer into the same IRA account or into another IRA. Rollovers are distinguished from trustee-to-trustee transfers, where the funds are paid directly by one IRA trustee to another IRA trustee, and conversions of traditional IRAs into Roth IRAs.

With respect to rollovers, a taxpayer does not have to include in his or her gross income any amount distributed from an IRA if that taxpayer deposits the amount into another eligible plan (including an

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IRA) within 60 days. This provides for a great deal of planning flexibility for taxpayers, allowing, for example, a taxpayer to use amounts in his or her IRA account for a short term financial need. As long as the amount withdrawn is re-deposited into a qualified account within 60 days, there is no income inclusion.

Note, however, that a rollover generally requires that 20% of the amount distributed be withheld for taxes. This is the case unless the payout: (1) is part of (or in excess of) a required minimum distribution; (2) a distribution that constitutes one of a series of substantially equal periodic payments; or (3) a hardship distribution from a 401(k) or 403(b) plan. A hardship distribution is one made on account of an immediate and heavy financial need that is necessary to satisfy that need. The financial need must be for medical care, housing, or educational expenses. A series of substantially equal periodic payments must be made at least annually for a specified period of at least ten years or for the life (or life expectancy) of the recipient or joint lives or expectancies of the recipient and his or her designated beneficiary.

The tax statute law limits the taxpayer to one IRA-to-IRA rollover in any 12-month period. In the past, the IRS has interpreted this limitation as applying on an IRA-by-IRA basis, meaning that a rollover from one IRA to another would not affect a rollover involving other IRAs of the same individual. In other words, a taxpayer could engage in as many rollovers as he or she wished, as long as they were from different IRA accounts.

This has all been changed, however, by a 2014 Tax Court decision involving tax attorney Alvan Bobrow. Alvan maintained two separate IRA accounts and during one year he took distributions from each of them. Arguably, he re-deposited the distributions within 60 days. The Tax Court held that the statute's limitation, contrary to the IRS's previous position, refers to any amount characterized as a nontaxable rollover contribution by virtue of that amount being repaid into a qualified plan within 60 days. In other words, the separate identity of multiple IRAs is irrelevant – one rollover per year is all that is allowed regardless of the number of accounts.

Shortly after the Tax Court decision in Bobrow, the IRS announced that it would apply the court's interpretation going forward. As a consequence, a taxpayer can make only a single rollover from one IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs the taxpayer owns. For the purpose of applying the limit, all of the taxpayer's IRA accounts are treated as one IRA, so that the limit is applied by aggregating all of the IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs.

Since the limitation only applied to rollovers, other transactions escape the application of the limit. For example, trustee-to-trustee transfers between IRAs are not limited. Likewise, conversions from traditional IRAs to Roth IRAs are not limited.

As a result of Bobrow, if the taxpayer receives a distribution from an IRA of previously untaxed amounts, he or she must include the amounts in gross income if they made an IRA-to-IRA rollover at any time during the preceding 12 months and will be subject to the 10% early withdrawal tax on the amounts included in gross income if the taxpayer has not reached the age of 59 1/2. If the limitation is violated and the taxpayer deposits the distributed amounts into another (or the same) IRA, such

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17 IRC § 408(d)(3).
18 IRC § 408(d)(3)(B).
20 There was a dispute as to the effective dates of the re-deposits.
amounts may be treated as excess contributions and taxed at 6% per year as long as they remain in the IRA.

**ADJUSTMENTS TO INCOME**

**Educator Expenses**

Eligible educators can deduct up to $250 of qualified expenses paid in 2016. If both spouses on a joint return are eligible educators the maximum deduction is $500. However, neither spouse can deduct more than $250 of his or her qualified expenses. For example, suppose Howard and Wendy are both eligible educators and file a joint return for 2016. Howard has $400 in qualified expenses and Wendy has $100 in qualified expenses. The maximum deduction on the joint return is $350 ($250 for Howard and $100 for Wendy).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide who worked in a school for at least 900 hours during a school year. Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. Starting in 2016, the cost of professional development courses is also considered a qualified expense.

**Expenses of Reservists, Performing Artists, and Fee-Basis Government Officials**

Members of a reserve component of the Armed Forces of the United States may take an above-the-line deduction for an amount attributable to the expenses for travel more than 100 miles away from home in connection with his or her performance of services as a member of the reserves.

Qualified performing artists may deduct amounts attributable to performing arts-related expenses. A qualified performing artist is someone who: (1) performed services in the performing arts as an employee for at least two employers during the tax year; (2) received from at least two of those employers' wages of $200 or more per employer; (3) had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts; and (4) had adjusted gross income of $16,000 or less before deducting expenses as a performing artist.

Also, individuals employed by a state or political subdivision of a state that are compensated, in whole or in part, on a fee basis may take an above-the-line deduction for what would otherwise be considered employee business expenses.

**Health Savings Account (HSA) Deduction**

Any eligible individual can contribute to an HSA. To be an eligible individual and qualify for an HSA, the taxpayer must: (1) be covered under a high deductible health plan (“HDHP”) on the first day of the month; (2) have no other health coverage; (3) not be enrolled in Medicare; and (4) not able to be claimed as a dependent on someone else's return. For 2016, if a taxpayer has self-only HDHP coverage, he or she can contribute up to $3,350. If he or she has family HDHP coverage, the taxpayer can contribute up to $6,750. An eligible individual who is age 55 or older at the end of the tax year can contribute an additional $1,000.

An HDHP must meet the minimum annual deductible and maximum out-of-pocket expense limitations. The minimum annual deductible and maximum out-of-pocket expense limitations for HDHPs for 2016 are illustrated in the following chart:
### Deductible and Out-of-Pocket Limits for High-Deductible Health Plans

<p>| | | |</p>
<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>HDHP minimum deductibles</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual coverage</td>
<td>$1,300</td>
<td></td>
</tr>
<tr>
<td>Family coverage</td>
<td>2,600</td>
<td></td>
</tr>
<tr>
<td>HDHP maximum out-of-pocket amounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual coverage</td>
<td>6,550</td>
<td></td>
</tr>
<tr>
<td>Family coverage</td>
<td>13,100</td>
<td></td>
</tr>
</tbody>
</table>

Any eligible individual can contribute to an HSA. For an employee's HSA, the employee, the employee's employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Family members or any other person may also make contributions on behalf of an eligible individual. Contributions to an HSA must be made in cash. Contributions of stock or property are not allowed.

All HSA contributions are reflected on Form 8889, which must be filed with the taxpayer's tax return. The taxpayer should include all contributions made for 2016, including those made by April 17, 2017, that are designated for 2016. Contributions made by the taxpayer's employer and qualified HSA funding distributions are also shown on the form.

### Moving Expenses

The taxpayer may be able to deduct moving expenses if he or she moved in connection with his or her job or business or started a new job during 2016. To qualify, the new workplace must be at least 50 miles farther from the taxpayer's old home than the taxpayer's old home was from his or her old workplace. If the taxpayer had no former workplace, the new workplace must be at least 50 miles from the taxpayer's old home.

### Deductible Part of Self-Employment Tax

Determining the portion of the self-employment tax that is deductible in determining AGI involves completing Schedule SE of Form 1040. Generally, Schedule SE must be completed for 2016 if the taxpayer had net earnings of $400 or more as a self-employed person, including the taxpayer's share of income from partnerships. Specifically, if the taxpayer was a general or limited partner in a partnership, the amount of net earnings from self-employment includes those amounts from Schedule K-1 (Form 1065), box 14, code A, and Schedule K-1 (Form 1065-B), box 9, code J1. General partners should reduce this amount by certain expenses before entering it on Schedule SE, as indicated on the Schedule K-1 instructions. Note that, if the amount entered on Schedule SE is reduced in this manner, the taxpayer must attach an explanation to Schedule SE. Limited partners include in self-employment income only guaranteed payments for services actually rendered to or on behalf of the partnership.

Deductions that reduce self-employment income to net income from self-employment are those that appear on Schedule C or Schedule F of Form 1040 or Schedule K-1 of Form 1065. Any adjustments to income that appear on the first page of Form 1040 (such as the deduction for self-employed health insurance, the deduction for contributions to a self-employed retirement plan, and
the deduction for one-half of the self-employment tax) reduce taxable income for purposes of the federal income tax, but not for the self-employment tax and the additional Medicare tax.

If the taxpayer is married and both the taxpayer and his or her spouse were partners in a partnership, each of spouse must report their respective net earnings from self-employment from the partnership on a separate Schedule SE and report the partnership income or loss on Schedule E (Form 1040), Part II, for income tax purposes. If only one spouse was a partner in a partnership, the spouse who was the partner must report his or her net earnings from self-employment from the partnership.

For spouses living in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin) the taxpayer’s own distributive share of partnership income is included in figuring the taxpayer’s net earnings from self-employment. Unlike the division of that income between spouses for figuring income tax, no part of the taxpayer’s share can be included in figuring the spouse’s net earnings from self-employment.

A mathematical equalization is then necessary to achieve parity between SECA and FICA. If the self-employed individual were an employee rather than self-employed, his or her employer would pay 7.65% of the wages earned as the employer portion of FICA. Therefore, once all of the net earnings from self-employment are combined, that number is multiplied by 92.35% (100% - 7.65%) to determine the base against which the self-employment tax is calculated. If the resulting amount is $118,500 or less in 2016, it is multiplied by 15.3% to arrive at the self-employment tax. If the amount exceeds $118,500 in 2016, the amount is multiplied by 2.9% and then added to $14,694 ($118,500 x 12.4%) to arrive at the self-employment tax.

One-half of the amount so calculated is then taken as a deduction in arriving at AGI on the first page of Form 1040. Note that the additional 0.9% Medicare tax is not considered a “self-employment” tax for this purpose. That tax is determined using Form 8959, not Schedule SE. Since only one-half of the amount of self-employment tax figured on Schedule SE is allowable as a deduction for AGI, no portion of the additional 0.9% Medicare tax is deducted in arriving at AGI.

**Self-Employed SEP, SIMPLE, and Qualified Plans**

Plan contributions for a self-employed individual are deducted as adjustments to gross income, not on the Schedule C. As a result, such contributions do not reduce self-employment tax. The self-employed individual can contribute up to 20 percent of his or her “adjusted net earnings from self-employment” or the yearly dollar limit, whichever is less. For 2016 the yearly dollar limit is $53,000. “Adjusted net income from self-employment” means the net earnings from self-employment multiplied by 92.35%.

For example, assume the taxpayer’s net earnings from self-employment in 2016 are $200,000. To calculate the deduction, you must first multiply the net earnings by 92.35% to find the adjusted net earnings. In this case the adjusted net earnings would be $184,700 ($200,000 x .9235). Next the adjusted net earnings are multiplied by 20% to arrive at the contribution limit. In this case that limit would be $36,940 ($184,700 x .20). If the taxpayers net self-employment earnings were $300,000, the adjusted net earnings would be $277,050 ($300,000 x .9235). Twenty percent of that amount would be $55,410, but in this case the deduction would be limited to $53,000 because that is the yearly dollar limit.
Self-Employed Health Insurance Deduction

A taxpayer may be able to deduct the amount he or she paid for health insurance for the taxpayer, the taxpayer’s spouse, and their dependents. The insurance can also cover a child of the taxpayer who was under age 27 at the end of 2016, even if the child was not the taxpayer’s dependent. A child includes a son, daughter, stepchild, adopted child, or foster child.

To be eligible for this deduction, one of the following statements must be true: (1) the taxpayer was self-employed and had a net profit for the year reported on Schedule C, C-EZ, or F; (2) the taxpayer was a partner with net earnings from self-employment; (3) the taxpayer uses one of the optional methods to figure net earnings from self-employment on Schedule SE; or (4) the taxpayer received wages in 2016 from an S corporation in which he or she was a more-than-2% shareholder. Health insurance premiums paid or reimbursed by the S corporation should be shown as wages on Form W-2.

The insurance plan must be established under the taxpayer’s business and the taxpayer’s personal services must have been a material income-producing factor in the business. If the taxpayer is filing Schedule C, C-EZ, or F, the policy can be either in the taxpayer’s name or in the name of the business.

Penalty on Early Withdrawal of Savings

If the taxpayer withdraws funds from a Certificate of Deposit or other deferred interest account before maturity, he or she may be charged a penalty by the financial institution holding the CD. The Form 1099-INT or similar statement provided by the financial institution will show the total amount of interest in Box 1 and will show the penalty separately in Box 2. The taxpayer can deduct the penalty, even if it is more than the interest income.

Alimony Paid

Alimony is generally defined as a cash payment from one spouse to another pursuant to a divorce or separation instrument. It is included in the gross income to the recipient spouse, and is deductible by the payor spouse in the year of receipt. Code section 71(b) sets forth five statutory requirements of alimony.

First, the payment must be in cash or a cash equivalent. The transfer of services or property or the use of property is not a cash equivalent, and neither is the execution or issuance of a promissory note or other debt instrument. Second, the payment must be made to, or on behalf of a spouse, pursuant to a divorce or separation instrument. The term “divorce or separation instrument” means (1) a decree of divorce, a decree of separate maintenance or a written instrument incident to a decree of divorce or separate maintenance; (2) a written separation agreement; or (3) a decree of spousal maintenance. A “decree” is basically a court judgment. A written instrument is “incident to a decree” if it is related to it.

The third requirement of alimony is that the divorce or separation instrument cannot specify that the payments are not alimony. Fourth, payments made while the couple lives together in the same household will not qualify as alimony. Even if there is some physical separation within the household (such as separate bedrooms, separate living space, etc.) any payments made will not be considered alimony. Finally, the divorce or separation instrument must provide for the termination of alimony payments after death of the recipient spouse.
IRA Deduction

For 2016 the total contributions to all traditional and Roth IRAs cannot be more than the lesser of $5,500 ($6,500 if age 50 or older); or the taxpayer's taxable compensation for the year. All or a portion of this amount may be deductible as an adjustment to income. If the taxpayer (or their spouse, if filing jointly) is covered by a retirement plan at work, the IRA deduction may be limited based on the taxpayer's modified AGI.

For taxpayers not covered by a retirement plan at work, the following chart summarizes the deduction status:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Modified AGI</th>
<th>Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single, head of household, or qualifying widow(er)</td>
<td>any amount</td>
<td>a full deduction up to the amount of the contribution limit</td>
</tr>
<tr>
<td>Married filing jointly or separately with a spouse who is not covered by a plan at work</td>
<td>any amount</td>
<td>a full deduction up to the amount of the contribution limit</td>
</tr>
<tr>
<td>Married filing jointly with a spouse who is covered by a plan at work</td>
<td>$184,000 or less</td>
<td>a full deduction up to the amount of the contribution limit</td>
</tr>
<tr>
<td></td>
<td>more than $184,000 but less than $194,000</td>
<td>a partial deduction.</td>
</tr>
<tr>
<td></td>
<td>$194,000 or more</td>
<td>no deduction.</td>
</tr>
<tr>
<td>Married filing separately with a spouse who is covered by a plan at work</td>
<td>less than $10,000</td>
<td>a partial deduction.</td>
</tr>
<tr>
<td></td>
<td>$10,000 or more</td>
<td>no deduction.</td>
</tr>
</tbody>
</table>

For taxpayers who are covered by a retirement plan at work, the following chart summarizes the deduction status:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Modified AGI</th>
<th>Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single or head of household</td>
<td>$61,000 or less</td>
<td>a full deduction up to the amount of the contribution limit</td>
</tr>
<tr>
<td></td>
<td>more than $61,000 but less than $71,000</td>
<td>a partial deduction.</td>
</tr>
<tr>
<td></td>
<td>$71,000 or more</td>
<td>no deduction.</td>
</tr>
<tr>
<td>Married filing jointly or qualifying widow(er)</td>
<td>$98,000 or less</td>
<td>a full deduction up to the amount of the contribution limit</td>
</tr>
<tr>
<td></td>
<td>more than $98,000 but less than $118,000</td>
<td>a partial deduction.</td>
</tr>
<tr>
<td></td>
<td>$118,000 or more</td>
<td>no deduction.</td>
</tr>
</tbody>
</table>
married filing separately | less than $10,000 | a partial deduction.  
$10,000 or more | no deduction.

**Student Loan Interest Deduction**

If the taxpayer's 2016 modified AGI is less than $80,000 ($160,000 if filing a joint return) there is a special deduction allowed for paying interest on a qualified education loan. Modified AGI for this purpose is the AGI as figured before subtracting any deduction for student loan interest. A “qualified education loan” is any indebtedness incurred by the taxpayer *solely* to pay qualified higher education expenses that are incurred on behalf of a student who is the taxpayer, the taxpayer’s spouse, or a dependent of the taxpayer as of the time the indebtedness was incurred. Someone who is eligible to be claimed as a dependent on another taxpayer’s return cannot take the student loan interest deduction.

As a result of the “*solely* to pay qualified higher education expenses” requirement, interest on mixed-use loans, such as a home equity loan that is used in part to pay qualified education expenses and in part for home improvements, does not qualify for the deduction. Furthermore, indebtedness owed to a person who is related to the taxpayer does not constitute a qualified education loan.

Generally, qualified education expenses include tuition, room and board, and related expenses for attending post-secondary educational institutions, including certain vocational schools, and certain institutions offering postgraduate training.

The student loan interest deduction can reduce the amount of the taxpayer's income subject to tax by up to $2,500 in 2016. The deduction begins to phase-out when modified AGI reaches $65,000 for single taxpayers and $130,000 on a joint return.

The phase-out amount is determined by multiplying the lesser of the interest paid on qualified educational loans or $2,500 by a ratio, the numerator of which is the modified AGI minus the phase-out threshold ($65,000 for single taxpayers and $130,000 for joint filers) and the denominator of which is either $15,000 (for single taxpayers) or $30,000 (for joint filers).

**EXAMPLE:** Yolanda is a single taxpayer with a modified AGI of $72,000. She pays $2,600 in student loan interest in 2016. Yolanda's student loan interest deduction would be $2,500 x ([($72,000 - $65,000] ÷ $15,000). The multiplier is $2,500 even though she paid $2,600 in interest because the lower of actual interest paid or $2,500 is used. $72,000 minus $65,000 is $7,000 and $7,000 divided by $15,000 is 46.7%, so Yolanda is entitled to a student loan interest deduction of $1,167.50 ($2,500 x 46.7%).

**Tuition and Fees**

A taxpayer may be able to deduct qualified education expenses paid during the year for himself or herself, his or her spouse, or dependent(s). A deduction cannot be claimed if the filing status is married filing separately or if another person can claim an exemption for the taxpayer as a dependent on his or her tax return. The tuition and fees deduction for 2016 is $4,000, $2,000, or $0, depending on the taxpayer’s modified AGI. If the modified AGI is not more than $65,000 ($130,000 if married filing jointly), the maximum tuition and fees deduction is $4,000. If the MAGI is larger than $65,000 ($130,000 if married filing jointly), but not more than $80,000 ($160,000 if married filing jointly), the maximum deduction is $2,000. No tuition and fees deduction is allowed if the MAGI is larger than $80,000 ($160,000 if married filing jointly).
Domestic Production Activities

Code section 199 generally provides for a deduction of 9% of the income from certain production activities, in addition to the otherwise allowable deduction for production costs. The domestic production activities deduction (“DPAD”) is calculated as 9% of the lesser of qualified production activities income or taxable income. Individuals use adjusted gross income instead of taxable income. The deduction is further limited to 50% of the employer’s W-2 wages for the tax year.

Qualified production activities income is calculated as the excess of domestic production gross receipts (“DPGR”) over the allocated cost of goods sold, direct costs, and allocable indirect costs. DPGR consist of amounts received from the sale, exchange, lease, rental, license, or other disposition of qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States.

STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

The Standard Deduction

All taxpayers are entitled to a standard deduction except those taxpayers filing married-separate returns whose spouses choose to itemize deductions. As described above, the standard deduction is composed of the “basic” standard deduction and an “additional” standard deduction for taxpayers who are age 65 or older, blind, or both. For the 2016 tax year the basic standard deduction for single taxpayers as well as those filing married-separate returns whose spouses do not itemize deductions is $6,300. Taxpayers who qualify for the head-of-household filing status get a standard deduction of $9,300. Married taxpayers who file married-joint returns are allowed a standard deduction of $12,600 on their 2016 joint return.

However, if a taxpayer can be claimed as a dependent but files his or her own return, the basic standard deduction for that taxpayer is the greater of: (i) $1,050 or (ii) $350 plus the individual’s earned income for the year (limited to a maximum of $6,300).

The additional standard deduction for those taxpayers filing single or head-of-household returns for 2016 is $1,550. The amount of the additional standard deduction for married taxpayers (whether filing married-joint or married separate) is $1,250.

If a taxpayer does not itemize deductions and later determines that itemizing would have been more beneficial, or if the taxpayer itemizes and later determines that they should not have, the selection can be changed by amending the return by filing Form 1040X. Note, however, that the statute of limitations for filing a claim for refund is generally the later of three years from the date the return was filed or two years from the date the tax was paid.

With respect to married persons who filed married-separate returns, the taxpayers can change methods of taking deductions only if both spouses make the same changes. Both of spouses must file a consent to assessment for any additional tax either one may owe as a result of the change.

SCHEDULE A AND THE PEASE LIMITATION

A taxpayer may elect to itemize his or her deductions on Schedule A of Form 1040 in lieu of taking the standard deduction discussed above. Itemized deductions are deductible expenses that are not allowed in computing AGI and include things like unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, state and local income or sales taxes, property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.
The Omnibus Budget Reconciliation Act of 1990 introduced a provision authored by Congressman Donald Pease (D-OH) that limited the total itemized deduction (other than medical expenses, investment interest, and casualty, theft, or wagering losses) of higher-income taxpayers beginning in 1991. This has since been known as the “Pease Limitation.”

The Pease Limitation was temporarily repealed by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”). The American Taxpayer Relief Act of 2012, however, made the Pease Limitation permanent for taxpayers with AGIs above certain thresholds. The 2016 AGI threshold for taxpayers filing married-joint returns is $311,300. The threshold limitation is $259,400 for single taxpayers, $285,350 for head-of-household filers, and $155,650 for married taxpayers filing married-separate returns for 2016.

In computing the reduction under the Pease Limitation, all other limitations applicable to itemized deductions (such as the 2% floor applicable to miscellaneous itemized deductions) are taken into account first. Then the otherwise allowable total amount of itemized deductions is reduced by 3% of the amount by which the taxpayer’s AGI exceeds the threshold amount. The Pease Limitation, however, cannot reduce itemized deductions to zero; the otherwise allowable itemized deductions cannot be reduced by more than 80 percent. Furthermore, the Pease Limitation does not apply to allowable deductions for medical expenses, investment interest, casualty and theft losses, and gambling losses.

**EXAMPLE:** Pete and Paula file a married-joint return for 2016 and have an AGI of $500,000 and $100,000 in itemized deductions in 2016. These taxpayers have $188,700 of AGI above the Pease Limitation threshold ($500,000 - $311,300). That excess is multiplied by 3% to determine the reduction in itemized deductions, which in this case would be $5,661 ($188,700 x 3%). The reduction amount is then subtracted from the otherwise allowable itemized deductions to produce allowable itemized deductions of $94,339 ($100,000 - $5,661).

In the above example, suppose the couple had an AGI of $3 million instead. In this case their excess AGI would be $2,688,700 ($3 million - $311,300) and the reduction would calculate to $80,661 ($2,688,700 x 3%). However, because the otherwise allowable itemized deductions cannot be reduced by more than 80%, the reduction in itemized deduction due to the Pease Limitation would be capped at $80,000 ($100,000 x 80%) and the taxpayers would still be allowed $20,000 in itemized deductions.

Finally, suppose the couple’s itemized deductions consisted entirely of deductions for medical expenses, investment interest, casualty and theft losses, and gambling losses. Since the Pease Limitation does not apply to those types of itemized deductions, there would be no reduction.

**State & Local Income Taxes**

Generally, state income, personal property, and real property taxes are deductible on Schedule A. To be deductible, the tax must be imposed on the taxpayer and must have actually been paid during the tax year. State income taxes are deductible whether they are paid through payroll withholding, estimated tax payments, or tax payments made with the filing of a state income tax return.

For purpose of the deduction for state and local income taxes, an analysis must sometimes be made as to whether a state tax is actually an income tax that is fully deductible for personal tax purposes or if it is some other kind of tax that may only be deducted only if incurred with respect to a business. For example, in 1987, the United States District Court for the Western District of Missouri approved a long-range capital improvement plan for the Kansas City, Missouri School District.
("KCMSD"). To provide funding for the capital improvement plan, the court also ordered that a 1.5% surtax be added to the Missouri State Income Tax on income earned within the KCMSD. The IRS held that the surtax constituted a state income tax deductible for federal income tax purposes. On the other hand, the tax imposed by Vermont on gain from the sale or exchange of certain land within the state was determined to be a transfer tax that was not deductible as a state income tax.

Real Estate Taxes

Deciphering which payments may be deducted as state and local real estate taxes can be a trickier proposition. While real estate taxes are deductible but special improvement payments are not. However, to be deductible a real property tax must be levied for the general public welfare at a like rate against all real property in the taxing authority's jurisdiction. Thus, amounts assessed only on specific properties benefited for streets, sidewalks, sewers and like improvements cannot be deducted as a real property tax.

While Code section 164(a)(1) permits a deduction for real property taxes, it does not define what constitutes a real property tax. That section does, however, require that a personal property tax be an "ad valorem" (literally, "according to value") tax to be deductible. The Code is silent with respect to any such requirement regarding real property taxes.

An example of the confusion this may cause is illustrated by a California law known as the Mello-Roos Community Facilities Act of 1982. That statute allows any California county, city, special district, school district or joint powers authority to establish a Community Facilities District ("CFD") which allows for financing of certain public improvements and services. The IRS Chief Counsel's Office concluded that California Mello-Roos and other assessments, depending on the facts and circumstances, may be deductible as real property taxes even though they are not imposed on an ad valorem basis. The standard seems to be that real property taxes are deductible if they represent assessments for the general public welfare and it is assessed ratably to all affected property owners, regardless of whether or not they are ad valorem taxes.

Only owners of property can deduct real estate taxes, as taxes are deductible only by the person on whom they are imposed. Real property taxes paid by a tenant to or for a landlord are considered additional rent; thus, the landlord rather than the tenant is allowed a deduction for the payment of the taxes. Housing cooperatives provide an exception to this rule. In a housing cooperative, the occupants own stock in the cooperative, not an interest in the real property. Nonetheless, an occupant-stockholder is allowed a deduction for the occupant-stockholder’s proportionate share of real estate taxes which are allowable as a deduction to the corporation and which are paid or incurred by the corporation on the houses or apartment building and the land on which such houses (or building) are situated.

Mortgage Interest

Mortgage interest payments constitute personal interest and, as such, would generally not be deductible. However, through a special provision in the Code, “qualified residence interest” may be deductible if the following three conditions are met:

1. The taxpayer itemizes deductions on Schedule A;

22 Rev. Rul. 80-121, 1980-1 CB 43.
2. The taxpayer is legally liable for the loan; and
3. The mortgage is secured by a qualified residence.

Mortgage interest payments are not deductible if they are made for someone else or if the taxpayer is not legally required to make them. Furthermore, both the taxpayer and the lender must intend that the loan be repaid and there must be a true debtor-creditor relationship.

Furthermore, the debt must be secured by a “qualified residence.” This term extends to both a principal residence and one other residence of the taxpayer. A taxpayer can have only one principal residence and one home treated as a second at any one time. The principal residence will ordinarily be where the taxpayer lives the majority of the time. A residence may include a house, condominium, cooperative, mobile home, house trailer, boat, or similar property, but must contain sleeping, cooking, and toilet facilities. Note that for AMT purposes, however, a qualified second residence includes only a house, apartment, condominium, or mobile home not used on a transient basis.

A secured debt is one in which there exists a signed instrument (such as a mortgage, deed of trust, or land contract) that:

1. Makes the taxpayer’s ownership in a qualified home security for payment of the debt;
2. Provides, in case of default, that the home could satisfy the debt; and
3. Is recorded or is otherwise perfected under any state or local law that applies.

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic’s lien or judgment lien that attaches to the property without the consent of the debtor.

Mortgage indebtedness generally must be an obligation of the taxpayer and not an obligation of another. However, taxpayers who are not directly liable on a mortgage may nevertheless deduct mortgage interest paid if he or she is the legal or “equitable” owner of the property subject to the mortgage. Factors established by judicial precedent to determine “equitable” ownership include:

1. Who has right to possess or use property?
2. Who pays property obligations such as taxes?
3. Who pays insurance?
4. Who maintains property?
5. Can property be improved without named borrower’s consent?
6. Who has risk of loss?
7. May legal title be obtained simply by paying balance of full purchase price?
8. Can “equitable title” be issued under state law?23

**EXAMPLE:** Pat and Mon Ela helped their son, Conrad, purchase a home in California. Conrad’s name was not on title but he did contribute a substantial sum towards the down payment. Conrad made 100% of the mortgage payments with the understanding that his parents would eventually transfer partial ownership to him. Although the IRS disallowed Conrad’s mortgage interest deduction

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23 See Blanche v. Commissioner, TC Memo 2001-63.
because he did not own the property that secured the mortgage and thus was not obligated to make the payments, the Tax Court held that Conrad had equitable ownership. Conrad testified that he and his parents considered the property to be the family home. He not only resided at the property, but he also bore a substantial risk of loss because he supplied a significant portion of the down payment and he agreed to be responsible for all of the mortgage payments. The court found that Conrad bore sufficient burdens and benefits of ownership and that he therefore held an equitable interest in the property. He was allowed to deduct mortgage interest as an “equitable owner.”

Qualified residence interest means any interest paid or accrued during the taxable year on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer. The aggregate amount treated as acquisition indebtedness for any period is limited to $1,000,000 ($500,000 in the case of a married taxpayer filing a separate return) and the proceeds of the debt must be used to acquire or construct a home. Home equity indebtedness is any debt (other than acquisition indebtedness) secured by taxpayer's qualified residence to the extent the aggregate amount of the debt does not exceed the fair market value of the residence reduced by the amount of acquisition debt outstanding. Note that the fair market value limitation only impacts the deductibility of home equity indebtedness interest. There is no such restriction on acquisition indebtedness.

EXAMPLE: Bill incurs $500,000 of acquisition debt to construct his principal residence. He later obtains a home equity loan in the amount of $50,000. In 2016 the balance of the acquisition debt and equity loan are $450,000 and $37,000, respectively, and Bill's home is worth $475,000. Bill can only deduct interest on $25,000 of home equity debt ($475,000 fair market value - $450,000 acquisition debt outstanding). If the fair market value of the home had fallen below $450,000, Bill could still deduct 100% of the interest on the acquisition debt.

Unlike acquisition debt, home equity debt generally may be used for any purpose without affecting its deductibility. However, the aggregate amount treated as home equity debt for any period may not exceed $100,000 ($50,000 for a married individual filing a separate return). However, for purposes of the alternative minimum tax (“AMT”), only home mortgage interest used to buy, build or substantially improve the taxpayer's principal residence or second home is deductible. Interest paid on home equity debt used for any other purpose is not deductible for the AMT.

The $1 million limit on acquisition debt applies per property, not per taxpayer.

EXAMPLE: Charles and Bruce purchased a home together with qualified home acquisition indebtedness of $2,000,000. Additionally, they had a $300,000 home equity line of credit. Both the acquisition debt and the home equity debt were obligations of both individuals and both were title owners of the home. Each paid one-half of the interest payments on both loans. Filing as two single taxpayers, Charles and Bruce each deducted the interest paid on the mortgages of $1.1 million. The Tax Court ruled that the $1,000,000 acquisition indebtedness and the $100,000 home equity borrowing limitations are applied on a per residence, not a per taxpayer, basis and limited the interest deductions for Charles and Bruce to the interest paid on the first $1.1 million.

Furthermore, the married-separate limits apply regardless of whether the other spouse takes a deduction or not.

EXAMPLE: Edith, who is married to Chris, obtained as $1 million mortgage to purchase her residence. Edith and Chris each file a married-separate return. Even though Chris does not deduct any mortgage interest on his return, Edith may only include $500,000 of mortgage debt to calculate her mortgage interest deduction. Whether the mortgage interest is claimed by the other spouse has no impact on the limitations that result when a married-separate return is filed.

Charitable Contributions

A taxpayer can take a charitable contribution deduction only for gifts to specified organizations that are tax-exempt under Code section 501(c)(3). Those organizations include community chests, corporations, trusts, funds, or foundations organized and operated only for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. Certain organizations that foster national or international amateur sports competition also qualify.

Qualified organizations also include war veterans’ organizations and domestic fraternal societies. However, a contribution to the latter type of organization is deductible only if it is to be used solely for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals; any other use renders the contribution non-deductible. A deductible contribution can also be made to certain nonprofit cemetery companies or corporations unless the donation is designated for the care of a specific lot or mausoleum crypt. Finally, a deductible contribution may be made to the United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions if it is to be used solely for public purposes.

Under treaty provisions, tax-deductible gifts may also be made to organizations in Canada, Mexico, and Israel, but only if the taxpayer has income from sources in those countries. Other specific treaty limitations apply to such donations.

Only contributions to organizations, not to individuals qualify for a tax deduction.

EXAMPLE: A community suffers a devastating flood destroying much property and leaving several families homeless. Dana gives cash to one of those families to help them obtain food. Larry makes a cash contribution to the American Red Cross, which in turn provides resources to the same family. Larry’s contribution is tax deductible, but Dana’s is not.

Furthermore, taxpayers are limited as to how much they can take in charitable contribution deductions. The limitation for any tax year is a percentage of taxpayer’s “contribution base” for the year, subject to an overall 50% ceiling for all charitable gifts. A taxpayer’s contribution base for a year is his or her AGI for the year without deducting any net operating loss carryback to that year. For taxpayers filing married-joint returns, the limitation applies to the couple’s combined contributions and combined contribution base.

Recipient charities are divided into “50% charities” and “30% charities.” Those charities in the former category are: (1) churches (or church conventions or associations); (2) tax-exempt educational organizations; (3) tax-exempt hospitals and certain medical research organizations; (4) certain organizations holding property for state and local colleges and universities; (5) a U.S. state or possession, or any political subdivision of any of these, or the U.S. or the District of Columbia, if the contribution is for exclusively public purposes; (6) organizations organized and operated exclusively for charitable, religious, educational, scientific or literary purposes, or for the prevention of cruelty to children or animals, or to foster national or international amateur sports competition if they
normally get a substantial part of their support from the government or general public; (7) certain private foundations; and (8) certain membership organizations more than one-third of whose support comes from the public. The latter category of 30% charities includes all other organizations entitled to receive tax-deductible contributions, including private non-operating foundations, war veterans’ organizations, fraternal orders, and cemetery companies.

If the taxpayer’s contributions for the year are all to 50% charities, the limit is 50% of the taxpayer’s contribution base except for contributions of appreciated capital gain property. The taxpayer’s deduction limit for gifts of appreciated capital gain property to 50% charities is 30% of the taxpayer’s contribution base. If the contributions for the year are all to 30% charities, the limit is 30% of taxpayer’s contribution base or, if less, 50% of his contribution base minus his contributions to 50% charities. The taxpayer’s deduction limit for gifts of appreciated capital gain property to 30% charities is 20% of the taxpayer’s contribution base.

Taxpayers must have written documentation of all amounts claimed as charitable deductions. The specific documentation required depends on the amount claimed. For claimed deductions of less than $250, the taxpayer must retain any reliable record, which may be a written receipt from the charity, a cancelled check, or a credit card statement.

A taxpayer must obtain a contemporaneous written acknowledgment from the donee organization for any contribution of $250 or more. The contemporaneous written acknowledgment does not have to indicate the specific value of the donation but must include: (1) a description of any property contributed; (2) a statement as to whether the donee provided any goods or services in exchange; and (3) a description and good faith estimate of the value of such goods or services.

For a non-cash contribution of more than $500 but not more than $5,000 the taxpayer must obtain a contemporaneous written acknowledgment from the charity and attach Form 8283, Noncash Charitable Contributions, to their return for the year of the donation.

For any non-cash contribution exceeding $5,000, the regulations require the donor to obtain a “qualified appraisal” for the contributed property, attach a fully completed appraisal summary on Form 8283 to the tax return on which the deduction is claimed, and maintain certain records pertaining to the claimed deduction.

The required records must include the name and address of the donee organization to which the contribution was made and the date and location of the contribution. The donor must also retain records describing the property in reasonable detail including the value of the property, and, in the case of securities, the name of the issuer, the type of security, and whether or not such security is regularly traded on a stock exchange or in an over-the-counter market. These records must reflect the fair market value of the property at the time the contribution was made, the method utilized in determining the fair market value, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser. The taxpayer’s records must also include the terms of any agreement or understanding relating to the use, sale, or other disposition of the property contributed.

In circumstances where less than the entire interest in the property is contributed, the taxpayer must maintain records indicating the total amount claimed as a deduction for the taxable year due to the contribution of the property and the amount claimed as a deduction in any prior year or years for contributions of other interests in such property, as well as the name and address of each organization to which any such contribution was made, the place where any such property which is tangible property is located or kept, and the name of any person, other than the organization to
which the property giving rise to the deduction was contributed, having actual possession of the property.

The term “qualified appraisal” means an appraisal that is prepared no earlier than 60 days prior to the donation nor later than the extended due date of the tax return for the year of the donation, conducted by a qualified appraiser in accordance with generally accepted appraisal standards, and not prepared for a fee based on a percentage of the appraised value of the donated item. A “qualified appraiser” must be someone who has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met certain minimum education and experience requirements set forth in regulations. Furthermore, a qualified appraiser must demonstrate verifiable education and experience in valuing the type of property subject to the appraisal and must regularly perform appraisals for compensation. Finally, it is important that the appraiser has not been prohibited from practicing before the IRS at any time during the three-year period ending on the date of the appraisal.

The appraisal report is required to include all of the following information:

1. A detailed description of the property;
2. With respect to tangible personal property, the property’s physical condition;
3. The date of the donation;
4. The terms of any agreement between the donor and the donee regarding the use or disposition of the donated property;
5. The name address, and tax identification number of the appraiser;
6. A description of the appraiser's qualifications including education, experience and memberships in appraisal organizations;
7. A statement that the appraisal is to be used for income tax purposes;
8. The date the property was appraised; and
9. The fair market value of the donated property on the date of the contribution.

In addition, the appraiser must include on his or her appraisal summary a declaration that the appraiser may be subject to a penalty if a substantial or gross valuation misstatement results from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund.

Appraisals are required when the aggregate amount of similar non-cash items exceeds $5,000. All similar property donated to one or more charities must be aggregated and treated as one property for purposes of the $5,000 appraisal requirement.

EXAMPLE: Georgette equally divides furniture with an aggregate value of $6,000 and donates $3,000 of it to one charity and $3,000 of it to a different charity. Even though the donation to each charity was under $5,000, Georgette will need an appraisal of all the items donated because the aggregate amount of similar non-cash items exceeds $5,000.

Generally, no deduction is allowed for a charitable gift of property consisting of less than the donor’s entire interest in that property. An exception to this rule exists in the case of a “qualified conservation contribution.” A qualified conservation contribution is a contribution of a “qualified real
property interest” to a donee that is a qualified charitable organization where the contribution will be used “exclusively for conservation purposes."

“Qualified real property interest” means a restriction, granted in perpetuity, on the use which may be made of the real property. Any interest retained by the donor must be subject to legally enforceable restrictions that will prevent uses of the retained interest in the property that are inconsistent with the conservation purposes of the contribution.

“Conservation purpose” means preservation of land areas, protection of natural habitat, preservation of open space (including farmland and forest land), or preservation of historically important land area or certified historic structure. A contribution is not treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.

In the case of a restriction with respect to the exterior of a building located in a registered historic district (a so-called “façade easement”), the qualified real property interest must include a restriction that protects the entire exterior of the building (including the front, sides, rear, and height of the building) and prohibits any change in the exterior that is inconsistent with the historical character of the exterior. Furthermore, the donor must enter into a written agreement with the donee certifying under penalties of perjury that the donee is a qualified organization and has the resources to manage and enforce the restriction and the commitment to do so. Finally, for a façade easement for which a deduction of more than $10,000 is claimed, no deduction is allowed unless the taxpayer includes a $500 filing fee with the return for the tax year of the contribution.

CHILD AND DEPENDENT CARE CREDIT
A tax credit is available for taxpayers who incurred employment-related expenses for the care of qualifying individuals. The amount of the credit is equal to an applicable percentage of the expenses paid by the taxpayer during the taxable year.

In order to qualify for the dependent care credit, the taxpayer must have incurred employment-related expenses for the care of a qualifying individual who resides in the taxpayer's household for more than one-half of the taxable year. If the taxpayer is married at the close of the taxable year, the credit is allowed only if the taxpayer and his or her spouse file a joint return for the taxable year. In other words, the credit cannot be claimed on a married- separate return. Note that a taxpayer who qualifies for head of household status is “considered unmarried” for tax purposes. Thus, a head of household filer can take this credit, even if they are still married for state law purposes at the end of the year.

A “qualifying individual” is: (1) a dependent under the age of 13, (2) a dependent who is physically or mentally incapable of caring for himself or herself and is residing in the same principal place of abode as the taxpayer for more than one-half of the taxable year, or (3) the taxpayer's spouse who is physically or mentally incapable of caring for himself or herself and is residing at the same principal place of abode as the taxpayer for more than one-half of the taxable year.

An individual is considered physically or mentally incapable if such individual is incapable of caring for his or her hygiene or nutritional needs, or requires full-time attention of another person for his or her own safety or the safety of others. An individual's inability to engage in any substantial gainful activity or to perform the normal household functions does not of itself establish physical or mental incapability. The status of whether a person is a qualifying individual is determined on a daily basis.

The credit is available only for employment-related expenses. Such expenses include only those amounts reasonably incurred to enable the taxpayer to be gainfully employed. A taxpayer's gainful
employment may consist of services within or outside the home, including self-employment. Whether the purpose of a household or care-giving expense is to enable the taxpayer to be gainfully employed depends on the facts and circumstances of each case.

The amount of employment-related expenses is capped to $3,000 for one qualifying individual or $6,000 for two or more qualifying individuals. The taxpayer may apply the limitations for two or more qualifying individuals in unequal proportions.

**EXAMPLE:** Ida has employment-related child care expenses of $4,000 for her son Jimmy and $1,500 in companion-sitter expenses for her dependent elderly mother Jane. Ida may take the full aggregate payment of $5,500 into account when determining the credit, even though the expenses related to one of the qualifying individuals exceeded $3,000. On the other hand, if the taxpayer only paid the child care expenses for Jimmy and had no expenses related to Jane, only $3,000 would count toward the credit.

The definition of “qualifying individual” for purposes of this credit incorporates residence with the taxpayer. As such, in the case of divorced or separated parents a child is treated as a qualifying individual of the custodial parent. Recall that the custodial parent is the parent having custody for the greater portion of the calendar year. In other words, the dependent care credit does not follow the dependency exemption when there has been a release of the exemption to the noncustodial parent.

**EDUCATION CREDITS**

Two credits that may apply to higher education expenses are the Lifetime Learning Credit and the former Hope Scholarship Credit, now reformulated and referred to as the American Opportunity Credit. To qualify for either of these credits, the taxpayer must have actually paid qualified tuition and related expenses for the enrollment or attendance of the taxpayer or the taxpayer's spouse or dependent at an eligible educational institution.

Qualifying expenses do not include expenses paid for any course or instruction involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program. Similarly, it does not include student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of study. Among the other expenses that do not qualify are:

1. Room and board;
2. Transportation;
3. Insurance;
4. Medical expenses;
5. Student fees (unless required as a condition of enrollment or attendance); and
6. Expenses that are paid with tax-free educational assistance.

An eligible educational institution is an institution which is eligible to participate in federal programs.

**American Opportunity Tax Credit**

Taxpayers may elect to take the American Opportunity Tax Credit (“AOTC”) by attaching Form 8863 to their original return or an amended return filed by the limitations period for filing a claim for credit or refund for the year the credit is claimed. The AOTC is a personal, partially refundable credit
equal to 100% of up to $2,000 of qualified higher education tuition and related expenses plus 25% of the next $2,000 of expenses paid for education furnished to an eligible student in an academic period, making the maximum credit $2,500 each year for each eligible student.

For 2016, the availability of the credit phases out ratably for taxpayers with modified AGI of $80,000 to $90,000 ($160,000 to $180,000 for married-joint returns). “Modified AGI” for this purpose is simply AGI increased by otherwise excluded income from foreign sources or U.S. territories. Married taxpayers must file jointly to claim the credit.

The AOTC may be elected for a student's expenses related to the first four years of post-secondary education. Once a student has completed four years of post-secondary education, the credit is no longer available with respect to that student. Additionally, for at least one academic period during the year for which the credit is taken, the student must be enrolled for at least half of the normal full-time workload for his or her course of study.

If an individual is claimed as a dependent by another taxpayer, the dependent cannot claim the AOTC, and qualified tuition and expenses paid by the dependent during the tax year are instead treated as paid by the taxpayer who is allowed the dependency deduction. If a third party, such as a grandparent, pays a student's qualified expenses directly to an educational institution, the student is treated as receiving the payment from the third party and, in turn, paying the expenses. If the student in such a case is a dependent, the expenses deemed to be paid by the student would be treated as expenses of the taxpayer claiming the student as a dependent. If a taxpayer is eligible to, but does not claim the student as a dependent, only the student himself or herself can claim the education credit for the qualified tuition and related expenses under these circumstances.

EXAMPLE: Joe is a student who incurs qualifying educational expenses in 2016. Those expenses are paid directly to the educational institution by Helen, Joe's grandmother. Joe is a dependent of his father Henry, but Henry does not claim Joe as a dependent and Joe files his own tax return. Under these circumstances the education expenses paid by Helen are deemed to be paid by Joe; if Henry had claimed Joe as a dependent, the expenses would have been deemed to be paid by Henry.

If qualified tuition and expenses are paid during one tax year for an academic period that begins during the first three months of the next tax year, the academic period is treated for AOTC purposes as beginning in the earlier year, so that the credit is allowed only in the tax year in which the expenses are paid.

EXAMPLE: In 2016 Jack pays qualified educational expenses related to his attendance at State University for the spring 2017 semester beginning in January, 2017. Because the spring semester begins within the first three months of Jack's 2017 tax year, the expenses are treated as paid for an academic period beginning in 2016.

Forty percent of the AOTC may be refundable. However, the credit is not refundable if at the end of the tax year at least one of the taxpayer's parents is alive, the taxpayer does not file a married-joint return, and the taxpayer was: (1) under age 18; (2) age 18 and has earned income equal to less than one-half of the taxpayer's total support; or (3) under age 24, a full-time student, and has earned income equal to less than one-half of the taxpayer's support. Essentially, if the AOTC is claimed by someone who qualifies as the dependent child of another taxpayer, the credit is not refundable.

Lifetime Learning Credit

The Lifetime Learning Credit is equal to 20% of up to $10,000 of qualified tuition and related expenses paid during the tax year for any post-secondary education. Thus, the maximum credit is
$2,000. Unlike the AOTC, which is available for the qualifying expenses of each qualifying student, the Lifetime Learning Credit is available only on a per taxpayer basis.

For 2016, the availability of the credit phases out ratably for taxpayers with modified AGI of $55,000 to $65,000 ($110,000 to $130,000 for married-joint returns). “Modified AGI” for this purpose is simply AGI increased by otherwise excluded income from foreign sources or U.S. territories. The same treatment of expenses paid by dependent, adjustment for tax-free scholarships, and denial of credit to those filing married-separate returns, that apply for AOTC purposes also apply to the Lifetime Learning Credit. Finally, expenses for a student for whom an AOTC is allowed for the tax year does not qualify for the Lifetime Learning Credit.

RETIREMENT SAVINGS CONTRIBUTION CREDIT
The Retirement Savings Contribution Credit ("Saver's Credit") is a mechanism whereby certain lower-income individuals can claim a nonrefundable credit against both income tax and alternative minimum tax for elective contributions to 401(k) plans, 403(b) annuities, Sec. 457 plans, SIMPLE or simplified employee pension (SEP) plans, traditional or Roth IRAs, and voluntary after-tax employee contributions to a qualified retirement plan or a 403(b) annuity. The credit rate is 50%, 20%, or 10%, of the taxpayer's retirement plan or IRA contributions up to $2,000 ($4,000 if married filing jointly), depending on the taxpayer's filing status and modified AGI. Thus, the maximum annual credit is $1,000 ($2,000 if married filing jointly). The amount of any credit-eligible contribution is reduced by taxable retirement plan distributions received by the taxpayer and spouse during a “testing period.”

A taxpayer is eligible for the Saver's Credit if they are: (1) 18 or older; (2) not a full-time student; and (3) not claimed as a dependent on another person's return. For this purpose, a full-time student is someone who, during any part of 5 calendar months of the tax year:

1. Was enrolled as a full-time student at a school, or
2. Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A “school” for this purpose includes technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or schools offering courses only through the Internet. As noted, the specific amount of the credit depends on the taxpayer’s modified AGI and filing status. For 2016 the amounts are as follows:

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<tr>
<th>2016 Saver’s Credit Percentages</th>
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<tr>
<td>Credit Rate</td>
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<tr>
<td>50% of contribution</td>
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For example, suppose Jill, who works at a retail store, is married and earned $30,000 in 2016. Jill’s husband was unemployed in 2016 and did not have any earnings. Jill contributed $1,000 to her IRA in 2016. After deducting her IRA contribution, the adjusted gross income shown on her joint return
is $29,000. Under these circumstances Jill may claim a 50% credit, $500, for her $1,000 IRA contribution.

Assume instead that Jill is single has adjusted gross income of $30,000 in 2016 and makes IRA contributions totaling $4,000. In this case Jill's Saver's Credit would be $200. This is because Jill's income and filing status ($30,000 of AGI and single) allows her a credit rate of 10% (see the chart above). Jill does not get a credit in the amount of 10% of her entire contribution because the credit applies only to contributions up to $2,000 ($4,000 in the case of married taxpayers filing jointly). Thus, despite the fact that she made $4,000 in IRS contributions, her credit amount is 10% x $2,000.

Note that rollover contributions (money that was moved from one qualified plan or IRA to another qualified or IRA) are not counted as contributions for the Saver's Credit. Also, the taxpayer's eligible contributions may be reduced by any recent distributions he or she received from a retirement plan or IRA. This rule applies to distributions received in the two years before the year the credit is claimed, the year the credit is claimed, and the period after the end of the credit year but before the due date - including extensions - for filing the return for the credit year. Form 8880, Credit for Qualified Retirement Savings Contributions, must be completed and attached to the taxpayer's federal income tax return to take the credit.

CHILD TAX CREDIT AND ADDITIONAL CHILD TAX CREDIT

The child tax credit is available for taxpayers with dependents under the age of 17. The full amount of the credit is $1,000 for each qualifying child. However, the amount is phased-out by $50 for each $1,000 by which the taxpayer's modified AGI exceeds a threshold amount. Unlike the dependent care credit, the child tax credit is refundable to the extent of 15% of the taxpayer's earned income in excess of a statutory or inflation-adjusted amount.

To qualify for the child tax credit, the taxpayer must have a qualifying child, meet the income limitations, and include the social security number of each qualifying child on his or her income tax return. A qualifying child of the taxpayer as defined for the dependency exemption is a child who has not reached the age of 17. This includes not only the taxpayer's natural, adopted, step, or foster child, but also the sibling, step-sibling, or descendant of any of those persons. Furthermore, the child tax credit only applies if the child is a U.S. citizen or resident alien.

The amount of the credit is reduced by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds specified amounts. For 2016 those amounts are $110,000 in the case of a joint return, $75,000 in the case of an individual who is not married, and $55,000 in the case of a married individual filing a separate return. “Modified AGI” for this purpose is simply AGI increased by otherwise excluded income from foreign sources or U.S. territories.

There is no express provision in the statute or regulations for allocating the child tax credit between divorced or separated individuals. Note, however, that the statute clearly provides that the child must satisfy the dependency requirements of Code section 152(c). Therefore, the credit should be allocated to the parent who is considered to have the qualifying child for dependency exemption purposes – that is, the parent who shares the same principal place of abode as the child for more than one-half of the taxable year. If the custodial parent has provided a written declaration releasing the dependency exemption to the noncustodial parent, then the credit may be taken by the noncustodial parent. Unlike the dependent care credit (discussed above), the child tax credit follows the dependency exemption.
AFFORDABLE CARE ACT (ACA) PROVISIONS

The Patient Protection and Affordable Care Act of 2010\textsuperscript{26} ("Affordable Care Act") contains comprehensive health insurance reform and includes tax provisions that affect individuals, families, businesses, insurers, tax-exempt organizations and government entities. These provisions contain important changes, including how individuals and families file their taxes. The law also contains benefits and responsibilities for other organizations and employers. The discussion below addresses the aspects of the Affordable Care Act that affect 2016 returns

Disclosure or Use of Information by Tax Return Preparers

Code section 7216 is a criminal provision enacted in 1971 that, except as provided in regulations, prohibits tax return preparers from knowingly or recklessly disclosing tax return information or using tax return information for a purpose other than preparing, or assisting in preparing, an income tax return. This provision applies to tax return preparers who also offer services and education related to the Affordable Care Act. Violators are subject to a $1,000 fine or a year in prison, or both. In addition to criminal penalties, a civil penalty of $250 for each unauthorized disclosure or use of tax return information by a tax return preparer is imposed by Code section 6713. The total amount imposed on any person cannot exceed $10,000 in any calendar year.

The regulations under Code section 7216 were revised to describe three circumstances when tax return information may be disclosed or used without taxpayer consent. Those regulations permit tax return preparers to use a list of client names, addresses, email addresses, phone numbers and each client’s income tax form number to provide clients with general educational information, including general educational information related to the Affordable Care Act. For example, a tax return preparer may mail general educational information to all clients regarding health care enrollment options available through the new health insurance marketplaces without obtaining consent.

However, tax return preparers who use tax return information to solicit and facilitate health care enrollment services must first obtain taxpayer consent to do so. For example, assume Preparer Z is also a health care “navigator” who would like to use tax return information to solicit and facilitate enrollment of eligible clients into qualified health plans available through the new health insurance marketplaces. Z must obtain taxpayer consent prior to using the tax return information in assisting taxpayers in connection with the solicitation and facilitation of the enrollment of Z’s eligible clients into qualified health care plans. Note that solicitation to offer health care enrollment services by all tax return preparers, including volunteer preparers, using tax return information, requires taxpayer consent.

Medical Loss Ratio (MLR)

Beginning in 2011, insurance companies are required to spend a specified percentage of premium dollars on medical care and quality improvement activities, meeting a medical loss ratio (MLR) standard. Insurance companies that are not meeting the MLR standard will be required to provide rebates to their consumers beginning in 2012. On December 7, 2011, the Department of Health and Human Services (HHS) issued final rules on the calculation and payment of medical loss ratio (MLR) rebates to health insurance policyholders.

\textsuperscript{26} 42 U.S.C. § 18001.
MLR rebates paid by an insurance company, either as cash payments or as premium reductions, are return premiums. Return premiums reduce the insurance company's taxable income. For a cash rebate paid to an individual policyholder, the insurance company is not required to file a Form 1099-MISC with respect to that payment or furnish a Form 1099-MISC to the individual policyholder unless: (1) the total rebate payments made to that policyholder during the year total $600 or more; and (2) Insurance company knows that the rebate payments constitute taxable income to the individual policyholder or can determine how much of the payments constitute taxable income. If the insurance company is required to file a Form 1099-MISC with respect to the rebate payment, it must also furnish a copy to the individual policyholder.

For a rebate paid to a group policyholder as a premium reduction, the insurance company is not required to file a Form 1099-MISC or furnish a copy to the group policyholder unless: (1) the group policyholder is not an exempt recipient for Form 1099 purposes; (2) the total rebate payments to that group policyholder during the year total $600 or more; and (3) the insurance company knows that the rebate payments constitute taxable income to the group policyholder or can determine how much of the payments constitutes taxable income.

**Reporting Employer Provided Health Coverage on Form W-2**

The Affordable Care Act requires employers to report the cost of coverage under an employer-sponsored group health plan on an employee's Form W-2, Wage and Tax Statement, in Box 12, using Code DD. The amount reported does not affect tax liability, as the value of the employer excludible contribution to health coverage continues to be excludible from an employee's income, and it is not taxable. This reporting is for informational purposes only, to show employees the value of their health care benefits.

All employers that provide “applicable employer-sponsored coverage” during a calendar year are subject to the reporting requirements, including federal, state, and local government entities, churches and other religious organizations, and employers that are not subject to the COBRA continuation coverage requirements, to the extent that these employers provide applicable employer-sponsored coverage under a group health plan. “Applicable employer-sponsored coverage” means, with respect to any employee, coverage under any group health plan made available to the employee by an employer, and which is excludable from the employee's gross income under Code Sec. 106, or would be so excludable if it were employer-provided coverage.

For these purposes, a “group health plan” is a plan (including a self-insured plan) of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families. An employer must include in the aggregate reportable cost: (1) the cost of coverage provided under hospital indemnity or other fixed indemnity insurance; or (2) the cost of coverage only for a specified disease or illness, if either the employer makes any contribution to the cost of coverage that is excludable under Code section 106, or the employee purchases the policy on a pre-tax basis under a cafeteria plan.

On the other hand, an employer does not need to include the cost of coverage in the aggregate reportable cost if: (1) those benefits are offered as independent, noncoordinated benefits; and (2) the payment for those benefits is includible in the employee's gross income (or, for a self-employed individual, the payment is one for which a deduction is allowable). Applicable employer-sponsored
coverage also does not include coverage for long-term care or any coverage under a separate policy or contract providing benefits for the treatment of the mouth or eye.

**Net Investment Income Tax**

A new Net Investment Income Tax (“NIIT”) went into effect on January 1, 2013. The 3.8 percent NIIT applies to individuals, estates and trusts that have certain investment income above certain threshold amounts. The new tax applies regardless of whether the individual is otherwise subject to Medicare taxes. For example, if an individual does not have earned income they are not subject to Medicare tax, but could still be subject to the new 3.8% tax on net investment income. Also, nonresident aliens are not subject to the NIIT unless the nonresident alien is married to a U.S. citizen or resident and makes an election under Code section 6013(g) to be treated as a resident alien so that the couple can file a joint.

The tax applies to individuals who have “modified adjusted gross income” in excess of: (1) $250,000 for joint filers and qualifying widows or widowers with dependent children; (2) $125,000 for married individuals filing separately; and (3) $200,000 for everyone else. For this purpose, “modified adjusted gross income” is regular adjusted gross income increased by the net amount, if any, of foreign-sourced income that is exempt for regular tax purposes under Code section 911(a)(1).

The tax also applies separately to trusts and to estates. Under the general rules for taxation, income accumulated inside the trust or estate is taxed to the entity, while distributed income is taxed to the beneficiaries up to the amount of the entity’s distributable net income (“DNI”).

Some trusts, however, are specifically excluded from the NIIT. For example, tax-exempt trusts (e.g., charitable trusts, charitable remainder trusts, and qualified retirement plan trusts) and trusts in which all of the unexpired interests are devoted to one or more charitable purposes are exempt from the NIIT. Also, trusts that are classified as “grantor trusts” are excluded from the tax, as are arrangements that are not classified as trusts for federal income tax purposes, such as real estate investment trusts (“REITs”).

Significantly, the triggering investment income amount for the new tax is much lower for trusts and estates. Trusts and estates are subject to the NIIT on undistributed net investment income if they have adjusted gross income over the dollar amount at which the highest applicable tax bracket begins. In 2016 the highest tax bracket for trusts and estates begins at $12,400; trusts and estates with undistributed net investment income over this amount will be subject to the tax.

In general, investment income includes, but is not limited to: interest, dividends, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer. Net capital gains are included as well, including gains from the sale of real estate and gains from the sale of interests in partnerships and S corporations as to which the taxpayer is a passive owner.

The NIIT does not apply to any amount of gain from the sale of a principal residence that is excluded from gross income for regular income tax purposes. Taxable gain from the sale of a principal residence, however, must be included as investment income for purposes of the NIIT. For example, suppose a single taxpayer bought a home ten years ago for $200,000 and sells that residence in 2013 for $420,000, realizing a gain of $220,000. Under Code section 121, the taxpayer can exclude the entire gain because it is less than the $250,000 maximum exclusion for single taxpayers. Because this gain is excluded for regular income tax purposes, it is also excluded for purposes of the
NIIT. If, however, the taxpayer had sold the house for a gain of $300,000, the amount of the gain in excess of the exclusion (i.e., $50,000) would be subject to the NIIT.

If the taxpayer reports interest, dividends, and capital gains of their children using Form 8814, the amount included on the taxpayer’s Form 1040 by reason of Form 8814 are included in the taxpayer’s investment income. However, investment income does not include: (1) amounts excluded from the taxpayer’s Form 1040 due to the threshold amounts on Form 8814; and (2) amounts attributable to Alaska Permanent Fund Dividends.

Finally, investment income for purposes of the NIIT does not include: (1) gross income derived in a trade or business that is not a passive activity with respect to the taxpayer (other than a trade or business of trading in financial instruments or commodities); and (2) gains from the sale of assets that are held in any such trade or business. When an individual, trust, or estate owns an interest in a trade or business that is conducted through a partnership or S corporation, the determination of whether income earned by the business is derived in a passive activity is made at the partner or shareholder level.

In order to arrive at net investment income, total Investment Income (as described above) is reduced by deductions that are properly allocable to items of such income. Examples of properly allocable deductions include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in investment income. For trusts and estates, net investment income is reduced by: (1) the share of net investment income included in the beneficiary distribution deduction of the trust or estate; and (2) the charitable deduction for amounts paid or permanently set aside for charitable purposes.

The new 3.8% NIIT is applied to the lesser of: (1) the taxpayer’s net investment income, or (2) the taxpayer’s modified adjusted gross income that exceeds the applicable threshold. Because the tax applies to the lesser of these two amounts, taxpayers whose modified adjusted gross income is below the threshold amount will not be subject to the new tax. Furthermore, if the amount by which the taxpayer’s modified adjusted gross income exceeds the threshold is less than the taxpayer’s net investment income, then the tax does not reach all of the taxpayer’s net investment income.

**Additional Medicare Tax**

Starting in 2013, the employee portion of the Medicare tax on wages is increased by an additional amount of 0.9% on wages received in excess of the threshold amount. Unlike the general 1.45% Medicare tax on wages, this additional tax is on the combined wages of the employee and the employee’s spouse in the case of a joint return. Also, rather than applying to all wages, the additional tax only applies to wages above the threshold amount, which is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Employers have limited responsibility to withhold the additional tax from the employee’s wages. In determining the employer’s requirement to withhold and liability for the tax, only wages that the employee receives from the employer in excess of $200,000 for a year are taken into account and the employer must disregard the amount of wages received by the employee’s spouse. Thus, the employer is only required to withhold on wages in excess of $200,000 for the year, even though the tax may apply to a portion of the employee’s wages at or below $200,000, such as when the employee’s spouse also has wages for the year, they are filing a joint return, and their total combined wages for the year exceed $250,000.
For example, if a taxpayer’s spouse has wages in excess of $250,000 and the taxpayer has wages of $100,000, the employer of the taxpayer is not required to withhold any portion of the additional tax, even though the combined wages of the taxpayer and the taxpayer’s spouse are over the $250,000 threshold. In this instance, the employer of the taxpayer’s spouse would be obligated to withhold the additional 0.9% tax only with respect to $50,000 of the spouse’s wages.

Unlike the employee portion of the general 1.45% Medicare tax for which the employee has no direct liability, the employee is liable for the additional 0.9% tax to the extent the tax is not withheld by the employer. Although an employee cannot direct his or her employer to withhold additional Medicare taxes if their wages are less than $200,000, the employee can always have an additional amount of income tax withheld, and this will apply to the Medicare tax liability. Alternatively, the employee can make quarterly estimated taxes to cover the additional amount.

This same 0.9% additional amount applies to Self-Employment Contributions Act (“SECA”) as well. The additional SECA tax is also applied only to the amount of earnings in excess of the threshold amount. Self-employment income and wages with respect to the same taxpayer (or the taxpayer and spouse in the case of a joint return) are combined for the purpose of applying the additional tax.

**Minimum Value**

An employer-sponsored plan provides minimum value if it covers at least 60 percent of the total allowed cost of benefits that are expected to be incurred under the plan. IRS Notice 2014-69 provides additional guidance regarding whether an employer-sponsored plan provides minimum value coverage if the plan fails to substantially cover in-patient hospitalization services or physician services. Employers generally must use a minimum value calculator developed by the Department of Health and Human Services (“HHS”) to determine if a plan with standard features provides minimum value. Plans with nonstandard features are required to obtain an actuarial certification for the nonstandard features. Information Reporting on Health Coverage by Employers

In 2016, applicable large employers (“ALEs”) with 50 or more full-time employees must use Forms 1094-C and 1095-C to report the information about offers of health coverage and enrollment in health coverage for their employees. Specifically, an ALE will use Form 1094-C to report summary information for each employee and to transmit Forms 1095-C to IRS. A separate Form 1095-C is used to report information about each employee. In addition, Forms 1094-C and 1095-C are used in determining whether an employer owes payments under the employer shared responsibility provisions (sometimes referred to as the “employer mandate”). Under the employer mandate, an employer can be subject to a penalty if it does not offer affordable minimum essential coverage that provides minimum value to substantially all of its full-time employees (and their dependents). Form 1095-C is also used in determining eligibility of employees for premium tax credits.

If an ALE offers health coverage through an employer-sponsored self-insured plan, the ALE also has to report more information on Form 1095-C (specifically, in Part III). For this purpose, a self-insured plan also includes a plan that offers some enrollment options as insured arrangements and other options are under self-insured options. In Part III, the ALE reports the name, SSN (or date of birth if SSN is not available), and coverage information about each individual (including any full-time employee and non-full-time employee, and any employee's family members) covered under the employer's health plan. If an individual was covered for some but not all the months of the year, an ALE has to indicate the months for which these individuals were covered in Part III.
If an employer provides health coverage in another manner, such as through an insured health plan or a multiemployer health plan, the issuer of the insurance or the sponsor of the plan providing the coverage will provide the information about the health coverage to any enrolled employees, and the employer should not complete Form 1095-C, Part III, for those employees. An employer that provides employer-sponsored self-insured health coverage but is not subject to the employer mandate, is not required to file Forms 1094-C and 1095-C and reports instead on Forms 1094-B and 1095-B for employees who enrolled in the employer-sponsored self-insured health coverage. On Form 1094-C, an employer can also indicate whether any certifications of eligibility for relief from the employer mandate apply.

Information Reporting on Health Coverage by Insurers

On March 5, 2014, the Department of the Treasury and IRS issued final regulations on minimum essential coverage information reporting. The information reporting is to be provided by health insurance issuers, certain sponsors of self-insured plans, government agencies and certain other parties that provide health coverage. Additionally, on July 9, 2013, the Department of the Treasury and the IRS issued Notice 2013-45 announcing transition relief for 2014 from this annual information reporting.

Small Business Health Care Tax Credit

This credit helps small businesses and small tax-exempt organizations afford the cost of covering their employees and is specifically targeted for those with low- and moderate-income workers. The credit is designed to encourage small employers to offer health insurance coverage for the first time or maintain coverage they already have. In general, the credit is available to small employers that pay at least half the cost of single coverage for their employees. On June 26, 2014, the Department of Treasury and the IRS issued final regulations on the credit, which include information on the requirement to purchase health insurance coverage through the Small Business Health Options Program (“SHOP”) Marketplace. The final regulations are applicable for taxable years beginning in or after 2014.

Application of the ACA to HRAs, FSAs and Other Employer Healthcare Arrangements

The Affordable Care Act’s market reforms apply to group health plans. On September 13, 2013, the IRS issued Notice 2013-54, which explains how the Affordable Care Act’s market reforms apply to certain types of group health plans, including health reimbursement arrangements (HRAs), health flexible spending arrangements (health FSAs) and certain other employer healthcare arrangements, including arrangements under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy. The notice also provides guidance on employee assistance programs or EAPs and on section 125(f)(3), which prohibits the use of pre-tax employee contributions to cafeteria plans to purchase coverage on an Affordable Insurance Exchange (also known as a Health Insurance Marketplace). The notice applies for plan years beginning on and after January 1, 2014, but taxpayers may apply the guidance provided in the notice for all prior periods.

Health Flexible Spending Arrangements

Effective January 1, 2014, the cost of an over-the-counter medicine or drug cannot be reimbursed from Flexible Spending Arrangements (“FSAs”) or health reimbursement arrangements unless a prescription is obtained. The change does not affect insulin, even if purchased without a
prescription, or other health care expenses such as medical devices, eye glasses, contact lenses, co-pays and deductibles. This standard applies only to purchases made on or after January 1, 2014. A similar rule went into effect on January 1, 2014, for Health Savings Accounts (“HSAs”), and Archer Medical Savings Accounts (“Archer MSAs”). Employers and employees should take these changes into account as they make health benefit decisions.

**Medical Device Excise Tax**

On December 5, 2014, the IRS and the Department of the Treasury issued final regulations on the new 2.3-percent medical device excise tax that manufacturers and importers will pay on their sales of certain medical devices starting in 2013. On December 5, 2014, the IRS and the Department of the Treasury also issued Notice 2014-77, which provides interim guidance on certain issues related to the medical device excise tax.

**Changes to Itemized Deduction for Medical Expenses**

Beginning January 1, 2013, a taxpayer can claim deductions for medical expenses not covered by his or her health insurance only when they exceed 10 percent of adjusted gross income. There is a temporary exemption until December 31, 2016, for individuals age 65 and older and their spouses.

**Health Insurance Premium Tax Credit**

Individuals and families can take a premium tax credit to help them afford health insurance coverage purchased through an Affordable Insurance Exchange (also known as a Health Insurance Marketplace). The premium tax credit is refundable so taxpayers who have little or no income tax liability can still benefit. The credit also can be paid in advance to a taxpayer’s insurance company to help cover the cost of premiums.

Premium tax credits are available only to individuals and families with household incomes between 100 percent of the federal poverty level. Household income includes the income of the taxpayer and any dependents who reside with the taxpayer. Furthermore, individuals who meet this income level are only eligible for the premium tax credit if they purchase coverage through the Health Insurance Marketplace, sometimes referred to as the Health Insurance Exchange, or simply the “Exchange.” The credit is not available for the purchase of insurance outside of the Exchange.

A taxpayer cannot receive the credit if he or she files a married filing separate return or if he or she can be claimed as a dependent of another taxpayer. Also, no credit is available with respect to a taxpayer or family member who is able to obtain affordable coverage through an eligible employer-sponsored plan that provides minimum value or through a government program, like Medicaid, Medicare, CHIP or TRICARE.

The Exchanges are responsible for the initial determination of eligibility for the premium tax credit. During enrollment through the Exchange, the Exchange will also determine if the taxpayer is eligible for advance payments of the premium tax credit. Advance credit payments are amounts paid directly to the insurance company on the taxpayer’s behalf; the taxpayer is responsible for paying the balance of the premium, if any.

If a taxpayer is eligible for, and chooses to receive the benefit of, an advance credit payment, the taxpayer must file a tax return to reconcile the amount of advance credit payments (which is always based on an estimate made by the Exchange) with the amount of the actual premium tax credit.
allowable determined at the end of the tax year. A taxpayer must file an income tax return for this purpose even if he or she is not otherwise not required to file a return.

The Exchange will issue the taxpayer a Health Insurance Marketplace statement, Form 1095-A, by January 31 following the tax year. This form shows the amount of the premiums for the health care plan or plans the taxpayer and their family members enrolled in and certain other information that is needed to compute the premium tax credit. Form 1095-A also reports any advance credit payments made on the taxpayer’s behalf.

Form 8962, Premium Tax Credit (PTC), is filed with the taxpayer’s return and is used to reconcile the amount of the advance credit payments to the amount of the actual premium tax credit allowable to the taxpayer. If the actual allowable premium tax credit computed on the return is more than the advance credit payments made during the year, the difference will be listed on the tax return as an additional tax payment (thereby increasing the refund or decreasing the amount of tax owed). If the advance credit payments are more than the amount of the actual allowable premium tax credit, the difference is reflected on the return as an additional tax amount. However, if the taxpayer’s household income is below 400 percent of the poverty level, limitations as to the amount of the excess credit that have to be repaid are applicable.

On November 7, 2014, the Department of the Treasury and IRS issued Notice 2014-71, which advises that an individual enrolled in a qualified health plan who becomes eligible for Medicaid coverage for pregnancy-related services that is minimum essential coverage, or for CHIP coverage based on pregnancy, is treated as eligible for minimum essential coverage under the Medicaid or CHIP coverage for purposes of the premium tax credit only if the individual enrolls in the coverage.

On November 4, 2014, the Department of the Treasury and IRS issued Notice 2014-69, which provides additional guidance regarding whether an employer-sponsored plan provides minimum value coverage if the plan fails to substantially cover in-patient hospitalization services or physician services.

On July 24, 2014, the Department of the Treasury and the IRS issued proposed, temporary and final regulations providing further guidance on the premium tax credit. In particular, the regulations provide relief for certain victims of domestic abuse or spousal abandonment from the requirement to file jointly in order to claim the premium tax credit. In addition, the regulations provide special allocation rules for reconciling advance credit payments, address the indexing in future years of certain amounts used to determine eligibility for the credit and compute the credit, and provide rules for the coordination between the credit and the deduction under Code section 162(l) for health insurance costs of self-employed individuals. Rev. Proc. 2014-41, also released on July 24, 2014, provides methods for determining the Code section 162(l) deduction and the premium tax credit for health insurance costs of self-employed individuals who claim the deduction under Code section 162(l).

On May 2, 2014, the Department of the Treasury and the IRS issued final regulations on the reporting requirements for Marketplaces.

On April 24, 2015, the IRS issued Notice 2015-37, which advises that an individual who may enroll in a CHIP buy-in program that HHS has designated as minimum essential coverage is eligible for minimum essential coverage under the program for purposes of the premium tax credit only for the period the individual is enrolled.
Individual Shared Responsibility Provision

Beginning in 2014, non-exempt U.S. citizens and legal residents are required to maintain “minimum essential coverage” for health care. Failure of the taxpayer to be covered under health insurance that provides at least minimum essential coverage results in the imposition of a penalty known as the “individual shared responsibility payment.” This is commonly referred to as the “individual mandate” and is designed to ensure a sufficiently diverse risk pool of insured persons to make overall coverage more affordable. Minimum essential coverage may be provided by government-sponsored programs, eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and grandfathered health insurance coverage, or any other coverage recognized by the Secretary of HHS in coordination with the Secretary of the Treasury.

Government-sponsored programs include Medicare, Medicaid, Children's Health Insurance Program, coverage for members of the U.S. military, veteran's health care, and health care for Peace Corps volunteers. Eligible employer-sponsored plans include: governmental plans, church plans, grandfathered plans and other group health plans offered in the small or large group market within a state.

“Minimum essential coverage” does not include contracts of insurance for long term care, limited scope dental and vision benefits, coverage for a disease or specified illness, hospital indemnity or other fixed indemnity insurance or Medicare supplemental health insurance.

Individuals are exempt from the requirement for months they are incarcerated, not legally present in the United States or maintain religious exemptions. Those who are exempt from the requirement due to religious reasons must be members of a recognized religious sect exempting them from self-employment taxes and adhere to tenets of the sect. Individuals residing outside of the United States are deemed to maintain minimum essential coverage. If an individual is a dependent of another taxpayer, the other taxpayer is liable for any penalty payment with respect to the individual for not maintaining minimum essential coverage.

The per-adult annual penalty was phased in as follows: $95 for 2014; $325 for 2015; and $695 in 2016. For years after 2016, the $695 amount will be adjusted for inflation, rounded to the next lowest $50. The percentage of income is phased in as follows: 1% in 2014; 2% in 2015; and 2.5% beginning in 2016. If a taxpayer files a married-joint return, the individual and his or her spouse are jointly liable for any penalty payment. The penalty applies to any period the individual does not maintain minimum essential coverage and is determined monthly. The penalty is an excise tax that is assessed in the same manner as an assessable penalty under the Code.

Notwithstanding the foregoing, the total household penalty may not exceed 300% of the per-adult penalty for the year. Thus for 2016 the maximum household penalty will be $2,085 (3 x $695). Furthermore, the total annual household payment may not exceed the national average annual premium for “bronze level” health plan offered through the state exchange that year for the household size.

For this purpose, family size is the number of individuals for whom the taxpayer is allowed a personal exemption. Household income is the sum of the modified AGI of the taxpayer and all individuals accounted for in the family size required to file a tax return for that year. Modified AGI for this purpose means AGI increased by all tax-exempt interest and foreign earned income.

Interestingly, although assessable and collectible under the Code, the IRS authority to use certain collection methods with respect to this excise tax penalty is limited. Specifically, the filing of notices
of liens and levies otherwise authorized for collection of taxes does not apply to the collection of this penalty. In addition, the statute waives criminal penalties for non-compliance with the requirement to maintain minimum essential coverage. However, the authority to offset refunds or credits is not limited by the provision. As a result, the only practical enforcement available to the IRS is to offset any refunds otherwise due to the taxpayer.

Individuals who cannot afford coverage because their required contribution for employer-sponsored coverage or the required premium for the lowest cost bronze plan obtainable through the state exchange exceeds 8% percent of household income for the year are exempt from the penalty. In years after 2014, the 8% exemption is increased by the amount by which premium growth exceeds income growth.

Also, no penalty is assessed for individuals who do not maintain health insurance for a period of 3 months or less during the tax year. If an individual exceeds the 3-month maximum during the tax year, the penalty for the full duration of the gap during the year is applied. If there are multiple gaps in coverage during a calendar year, the exemption from penalty applies only to the first such gap in coverage.

**EXAMPLE:** Victor experiences a lapse in coverage for the entire month of February, 2016, but is covered again beginning March 1. He experiences a second lapse in coverage during the months of September and October of 2016. The penalty is only waived with respect to the February gap in coverage; a penalty will be assessed for the September-October gap, even though that gap does not put Victor over the 3-month maximum.

**Health Coverage for Older Children**

Health coverage for an employee's children under 27 years of age is now generally tax-free to the employee. This expanded health care tax benefit applies to various work place and retiree health plans. These changes immediately allow employers with cafeteria plans -- plans that allow employees to choose from a menu of tax-free benefit options and cash or taxable benefits -- to permit employees to begin making pre-tax contributions to pay for this expanded benefit. This also applies to self-employed individuals who qualify for the self-employed health insurance deduction on their federal income tax return.

**Excise Tax on Indoor Tanning Services**

A 10-percent excise tax on indoor UV tanning services went into effect on July 1, 2010. Payments are made along with Form 720, *Quarterly Federal Excise Tax Return*. The tax doesn't apply to phototherapy services performed by a licensed medical professional on his or her premises. There's also an exception for certain physical fitness facilities that offer tanning as an incidental service to members without a separately identifiable fee.

**Adoption Credit**

For tax year 2016, the credit is nonrefundable, with a maximum amount (dollar limitation) of $13,460 per child. Unused credit amounts can be carried forward up to five years. For 2016, adopting parents who earn no more than $201,920.00 are entitled to take the full credit. For adopting parents who earn between $201,920.00 and $241,920.00 in income, there is a reduced tax credit, and no tax credit is available for those earning more than $241,920.00. Parents who adopted a child who has been determined to have special needs by the state or county child welfare agency
can claim the maximum credit regardless whether they have qualified adoption expenses at all or have spent any money to adopt the child.

**Group Health Plan Requirements**

The Affordable Care Act establishes a number of new requirements for group health plans. Interim guidance on changes to the nondiscrimination requirements for group health plans can be found in Notice 2014-1, which provides that employers will not be subject to penalties until after additional guidance is issued. Additionally, TD 9575 and REG-140038-10, issued by DOL, HHS and IRS, provide information on the summary of benefits and coverage and the uniform glossary. Notice 2015-59 provides guidance to group health plans on the waiting periods they may apply before coverage starts. On June 20, 2014, HHS, DOL and IRS issued final regulations on the ninety-day waiting period limitation.

Further, Notice 2013-54 provides guidance regarding the application of the Affordable Care Act's market reforms to certain types of group health plans, including health reimbursement arrangements (HRAs), health flexible spending arrangements (health FSAs) and certain other employer healthcare arrangements, including arrangements under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy.

**Limitation on Deduction for Compensation Paid by Certain Health Insurance Providers**

The Affordable Care Act amended section 162(m) of the Code to limit the compensation deduction available to certain health insurance providers. The amendment went into effect for taxable years beginning after December 31, 2015, but may affect deferred compensation attributable to services performed in a taxable year beginning after December 31, 2009. On September 18, 2014, the Treasury Department and IRS issued final regulations on this provision.

**Employer Shared Responsibility Payment**

The Affordable Care Act establishes that certain employers must offer health coverage to their full-time employees or a shared responsibility payment may apply. On February 10, 2014, the Department of the Treasury and the IRS issued final regulations on the Employer Shared Responsibility provisions.

**Excise Tax on High Cost Employer-Sponsored Health Coverage**

Section 4980I, which was added to the Code by the Affordable Care Act, was to apply to taxable years beginning after December 31, 2017. Under this provision (sometimes referred to as the “Cadillac Tax,” there is imposed a 40% tax on employers who offer premium health insurance plans that exceed specified high-cost limits ($10,200 for individuals and $27,000 for families). The 40% tax applies to the amount above the cost threshold. Thus, for an individual plan that costs $11,000, the tax would be $320 (40% of the $800 over the $10,200 limit).

The PATH Act, signed into law on December 18, 2015, pushes back the start of the Cadillac Tax from 2018 to 2020. Consequently, the provisions of Code section 4980I will apply to taxable years beginning after December 31, 2019.
Retiree Drug Subsidies

Under Code section 139A, certain special subsidy payments for retiree drug coverage made under the Social Security Act are not included in the gross income of plan sponsors. Plan sponsors receive these retiree drug subsidy payments based on the allowable retiree costs for certain qualified retiree prescription drug plans. For taxable years beginning on or after January 1, 2013, new statutory rules affect the ability of plan sponsors to deduct costs that are reimbursed through these subsidies.

EARNED INCOME TAX CREDIT (EITC)

The earned income tax credit (“EITC”) is a social welfare program that provides subsidies to taxpayers whose earned income is below certain thresholds. The credit, which only applies to taxpayers who have some amount of earned income, is refundable to the extent it exceeds the taxpayer's federal income tax liability. The maximum amount of the EITC is $6,269 in 2016 for joint filers with three or more qualifying children. The maximum 2016 credit is reduced to $5,572 for taxpayers with only two qualifying children and $3,373 if the taxpayer has only one qualifying child. A taxpayer may qualify for a maximum EITC of $506 in 2016 if they have no qualifying children.

The specific amount of the EITC applicable to a taxpayer is equal to a specified percentage of earned income up to the maximum dollar amounts identified above. The maximum amount applies over a certain income range and then diminishes to zero over a specified phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phase-out range, the maximum EITC amount is reduced by the phase-out rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65 and their AGI is less than $14,880 in 2016 ($20,430 if filing a married-joint return). Taxpayers with one qualifying child may receive an EITC if their 2016 AGI is below $39,296 ($44,846 if filing a married joint return) and those with two qualifying children are eligible as long as their AGI does not exceed $44,648 ($50,198 for married-joint returns). Finally, any taxpayer with three or more qualifying children may receive an EITC for 2016 if their AGI is less than $47,955 ($53,505 for married-joint returns).

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying
children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

Finally, an individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,400 in 2016. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

**TAX WITHHOLDING AND ESTIMATED TAX PAYMENTS**

Taxpayers who receive wage income will generally be subject to withholding of federal income taxes from their wages unless they had no tax liability for the previous year and expect to have no tax liability for the current year. An employee indicates their qualification for exemption from withholding on a properly completed Form W-4 provided to the employer for each year for which they are claiming an exemption.

Payments other than wages may also be subject to withholding, such as gambling winnings. Making estimated tax payments is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes and awards. Estimated tax payments may also have to be made whenever the taxpayer does not have a sufficient amount of tax withheld from his or her wages or other payments. Using the Electronic Federal Tax Payment System (“EFTPS”) is the easiest way to pay estimated federal taxes for individuals as well as businesses.

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. In 2016 the due dates are: April 18, 2016 (for the period January 1 – March 31); June 15, 2016 (for the period April 1 – May 31); September 15, 2016 (for the period June 1 – August 31); and January 17, 2017 (for the period September 1 – December 31). If a taxpayer does not pay enough tax by the due date of each of the payment periods, a penalty may be charged even if the taxpayer is due a refund.

**EXAMPLE:** Bobby earns self-employment income evenly throughout the year, and his required estimated tax payments are calculated to be $2,000 each quarter. Bobby does not make any estimated tax payments for the first three quarters but instead makes an estimated payment of $9,000 in the fourth quarter. Although Bobby may have overpaid his tax liability by $1,000, he may be subject to a late payment penalty with respect to the first three quarters.

If a taxpayer does not pay enough tax throughout the year in withholding and estimated payments, he or she may be subject to a penalty for underpayment of estimated tax. Generally, most taxpayers will avoid this penalty if they owe less than $1,000 in tax after subtracting their withholdings and credits, or if they paid at least 90% of the tax for the current year, or 100% of the tax shown on the return for the prior year, whichever is smaller. There are special rules for farmers and fishermen.

Furthermore, the penalty may also be waived if the underpayment was caused by a casualty, disaster, or other unusual circumstance and it would be inequitable to impose the penalty, or if the taxpayer is retired (after reaching age 62) or became disabled during the tax year for which estimated payments were required to be made or in the preceding tax year, and the underpayment was due to reasonable cause and not willful neglect. Form 2210 can be used to request a waiver of the penalty under any of these circumstances.
PAYMENT AND REFUND OPTIONS

Taxpayers may submit paper checks or money orders through the mail to the IRS or may deliver payments to an IRS office. The IRS also offers various electronic payment options for paying federal taxes, most of which require the payment of user fees.

If a taxpayer owes taxes but cannot pay the full amount by the due date, the taxpayer should always still file the return on time and pay as much as possible to avoid penalties and interest. There are several options that may be available to make payments. For example, the taxpayer may be granted a short additional time to pay his or her tax in full. Such brief additional amounts of time to pay can be requested through the Online Payment Agreement application or by calling 800-829-1040, without the need to go through a formal Installment Agreement. Taxpayers who request and are granted an additional 60 to 120 days to pay the tax in full generally will pay less in penalties and interest than if the debt were repaid through an installment agreement over a greater period of time.

A taxpayer can also apply for an IRS installment agreement using the Web-based Online Payment Agreement ("OPA") application on irs.gov. This Web-based application allows taxpayers who owe $25,000 or less in combined tax, penalties and interest to self-qualify, apply for, and receive immediate notification of approval. The taxpayer can also request an installment agreement before his or her current tax liabilities are actually assessed by using OPA. The taxpayer also has the option of completing and submitting a Form 9465, Installment Agreement Request. For balances over $25,000, the taxpayer is required to complete a financial statement to determine the monthly payment amount for an installment plan.

Taxpayers have three options for receiving their individual federal income tax refund:

1. Direct deposit (electronic funds transfer) into a checking or savings account, including an individual retirement arrangement (IRA);
2. Purchase of U.S. Series I Savings Bonds; or
3. Paper check.

If the taxpayer chooses to receive his or her refund by direct deposit, they can request that the refund be deposited in up to three separate accounts by completing Form 8888, Allocation of Refund (Including Savings Bond Purchases).

A taxpayer who e-files a complete and accurate tax return should receive their refund within 21 days of date the return is received by the IRS. A complete and accurate paper tax return refund will usually be issued within six to eight weeks from the date the return is received by the IRS.

In an effort to combat fraud and identity theft, new IRS procedures effective January 2015 will limit the number of refunds electronically deposited into a single financial account or pre-paid debit card to three. The fourth and subsequent refunds automatically will convert to a paper refund check and be mailed to the taxpayer. Taxpayers will also receive a notice informing them that the account has exceeded the direct deposit limits and that they will receive a paper refund check in approximately four weeks if there are no other issues with the return.

The purpose of the direct deposit limit is to prevent criminals from easily obtaining multiple refunds. The limit applies to financial accounts, such as bank savings or checking accounts, and to prepaid, reloadable cards or debit cards. However, the limitation may also affect some taxpayers, such as families in which the parent’s and children’s refunds are deposited into a family-held bank account.
Taxpayers in this situation should make other deposit arrangements or expect to receive paper refund checks.

Note that direct deposit must only be made to accounts bearing the taxpayer’s name. Preparer fees cannot be recovered by using Form 8888 to split the refund or by preparers opening a joint bank account with taxpayers. These actions by preparers are subject to penalty under the Internal Revenue Code and to discipline under Treasury Circular 230.
IRC 6695(A)

Requirement to Furnish Taxpayer with a Copy of a Return and Related Penalty for Not Doing So

Any person who prepares all or any substantial portion of a return or claim for refund who fails to furnish a completed copy of such return or claim to the taxpayer not later than the time such return or claim is presented for such taxpayer's signature is subject to a penalty of $50, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year may not exceed $25,000.

IRC 6695(B)

Requirement for Signing the Return as a Return Preparer and Related Penalty for Not Doing So

When a person prepares another person's income tax return for compensation, the preparer must sign the return. Generally, the preparer must sign the return after it is completed and before it is presented to the taxpayer for signing. Whenever a document is prepared for a taxpayer by another person for compensation and that return or document must be verified by a written declaration under penalties of perjury, the preparer must so verify the return or document.

Any person who is a tax return preparer with respect to any return or claim for refund, who is required by regulations prescribed by the Secretary to sign such return or claim, and who fails to comply with such regulations with respect to such return or claim shall pay a penalty of $50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000.

IRC 6695 (C)

Requirement to Furnish Identifying Number as Return Preparer and Related Penalty for Not Doing So

Anyone who is paid to prepare or assist in preparing federal tax returns or claims for refund must have a preparer tax identification number ("PTIN"). All enrolled agents must also have a PTIN. Attorneys and Certified Public Accountants practicing before the IRS do not need a PTIN unless they are compensated for preparing or assisting in preparing federal tax returns or claims for refund. A PTIN cannot be shared among multiple individuals or one office. Each individual must obtain his or her own PTIN.

The Code provides that any return or claim for refund prepared by a tax return preparer must contain the PTIN of the preparer. Any preparer who fails to comply with this requirement is subject to a penalty of $50 for each such failure, unless it is shown that such failure is due to reasonable
cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year is limited to $25,000.

IRC 6695(D)

Requirement to Retain Copy of Return or List and Related Penalty for Not Doing So

Any person who prepares all or any substantial portion of a return or claim for refund who fails to retain, for at least three years after the close of the return period, a completed copy of the return or claim, or a list of the name and taxpayer identification number of the taxpayer for whom such return or claim was prepared, or who does not make such copy or list available for inspection upon request by the IRS, is subject to a penalty of $50 for each such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any preparer with respect to any one year may not exceed $25,000.

IRC 6695(F)

Prohibition on Negotiation of Client Refund Checks

Any preparer who endorses or otherwise negotiates (directly or through an agent) any refund check issued to a client is subject to a penalty of $500 with respect to each such check. This prohibition applies not only to illegal endorsements (i.e., forgeries) but also to otherwise legal transactions where a preparer endorses or negotiates a check issued to a taxpayer by reason of a power of attorney or upon an initial endorsement by the taxpayer.

Thus, the attempted assignment of a taxpayer's refund check to the preparer before IRS processes the return is not a valid assignment as to the IRS, and the check may be mailed directly to the taxpayer. Furthermore, a preparer who operates a check cashing business and who cashes, endorses, or negotiates income tax refund checks for individuals whose returns he or she prepared is subject to this penalty.

DUE DILIGENCE IN PREPARING RETURNS

(e.g., appropriate use of Form 8867)

Special requirements apply to preparers that prepare returns claiming the EITC. Under Code section 6695(g), a penalty of $500 may be imposed on a person who prepares a tax return for a taxpayer claiming the EITC, unless the tax return preparer exercises due diligence with respect to that claim. The due diligence requirements extend to both the determination of eligibility for the credit and the amount of the credit, as prescribed by regulations, which also detail how to document one's compliance with those requirements. The position taken with respect to the EITC must be based on current and reasonable information that the paid preparer develops, either directly from the taxpayer or by other reasonable means. The preparer may not ignore implications of information provided by taxpayers, and is expected to make reasonable inquiries about incorrect, inconsistent or incomplete information.

Specifically, the tax return preparer must complete Form 8867, Paid Preparer’s Earned Income Credit Checklist. Form 8867 must be physically submitted with the tax return or claim for refund. The Form 8867 is a checklist paid preparers are required to complete to meet their due diligence requirements with respect to the EITC. Completing the Form 8867 is an important aspect of the due diligence process for preparers working on EITC returns, but it is not the only requirement, as discussed
Furthermore, preparers are cautioned that tax preparation software cannot be depended upon to comply with these due diligence requirements. Tax software is merely a tool to assist in the preparation of the return and is not a substitute for knowledge of tax law and professional responsibility.

Practitioners are not required to verify any information provided to them by taxpayers, but may rely in good faith on the information so provided. As noted above, however, Circular 230 does not allow the preparer to ignore the implications of information that is available to them and the practitioner must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete. Note that only paid preparers are required to complete Form 8867.

In the case of a signing tax return preparer electronically filing the tax return or claim for refund, the preparer must electronically file the completed Form 8867 with the tax return or claim for refund. In the case of a signing tax return preparer not electronically filing the tax return or claim for refund, the preparer must provide the taxpayer with the completed Form 8867 for inclusion with the filed tax return or claim for refund. Finally, in the case of a non-signing tax return preparer who participates in the preparation of return to be signed by another preparer, such person must provide the signing tax return preparer with the completed Form 8867, in either electronic or non-electronic format, for inclusion with the filed tax return or claim for refund.

Given the additional responsibility imposed on preparers with regard to EITC returns, preparers may want to consider actually examining the taxpayer's social security card when preparing the Form 8867. A social security number issued by the Social Security Administration is not valid for purposes of the EITC if “Not Valid for Employment” is printed on the card and the number was issued solely to allow the taxpayer to apply for or receive a federally funded benefit. If the social security card specifies "Valid for Work Only with DHS Authorization," the taxpayer can take the EITC as long as the taxpayer’s Department of Homeland Security (“DHS”) authorization is still valid.

With respect to children, only the first name of the child must be entered on Form 8867 unless more than one child has the same first name. In that case, the preparer should enter other identifying information to distinguish between the two children. As noted above, a child that has been legally adopted is treated the same as the taxpayer's natural child for all tax purposes, including the EITC, and a foster child must be placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction. The term “descendant” for purposes of Form 8867 includes not only a grandchild or great-grandchild of the taxpayer, but also a child, grandchild, or great-grandchild of the taxpayer's brother, sister, stepbrother, stepsister, half-brother, or half-sister.

A child who was born or died during tax year and lived in the taxpayer's home for more than half the time the child was alive during the year is deemed to have lived with the taxpayer in the United States for over half of the year. This is also true if the child lived with the taxpayer for over half of the year in one or more homeless shelters in the United States. Temporary absences (such as time spent at a summer camp, in the hospital, etc.) may count as time lived at home. Finally, military personnel on extended active duty outside the United States are considered to be living in the United States during that duty period.

If a child meets the requirements for being a qualifying child of both the taxpayer and at least one other person, only one of those individuals can treat the child as a qualifying child. As a result, only that person is entitled to a dependency exemption and the child tax credit for that child.
Furthermore, only the person treating the child as a qualifying child may use that child as a basis for claiming head of household filing status, the credit for child and dependent care expenses, the exclusion for dependent care benefits, and the EITC.

**EXAMPLE:** John and Jane are the unmarried parents of Billy. John, Jane, and Billy all live in the same household and neither has any other children or dependents. As a result, Billy is potentially the qualifying child of either John or Jane. However, only one of them can use Billy as a qualifying child for purposes of the EITC; the other cannot count Billy as a qualifying child and cannot take the dependency exemption or the child tax credit, cannot file as head of household, take the credit for child and dependent care expenses, or exclude dependent care benefits provided by his or her employer.

Note that the result is somewhat different if John and Jane are divorced or legally separated and live apart, or lived apart during the last six months of the year (whether or not they were ever married). In that case, if the parent with physical custody of Billy provides the other parent with a signed Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*, and the non-custodial parent attaches that form to his or her return, only the non-custodial parent can claim a dependency exemption and the child tax credit for the child. However, the non-custodial parent cannot claim the child as a qualifying child for head of household filing status, the credit for child and dependent care expenses, or exclude dependent care benefits provided by his or her employer.

Another due diligence requirement regarding the EITC applicable to preparers deals with maintaining records reflecting the computation of the credit. Specifically, a preparer must maintain a physical record of his or her EITC computation, including the method and information used to make the computation. This can be accomplished by either completing the Earned Income Credit Worksheet contained in the Form 1040 instructions, or by otherwise recording his or her EITC computation. The preparer’s completion of the worksheet, or other record of his or her EITC computation, must be based on information provided by the taxpayer, or must be reasonably obtained by the preparer.

In addition to completing the Form 8867 and the retention of records regarding the computation of the credit, the preparer must not have knowledge that any information used in determining the taxpayer’s eligibility for, or the amount of, the EITC is incorrect. Under this rule, preparers cannot simply put blinders on, or hide their head in the sand, as it encompasses not only actual knowledge, but also things which the preparer has reason to know. Consequently, a preparer who ignores facts that are obviously implied from the circumstances cannot take refuge in some contorted notion of what they did and did not know. To the contrary, the preparer has an affirmative obligation to evaluate the information received from the taxpayer, apply a consistency and reasonableness standard to that information, ask additional questions when appropriate, and make reasonable inquiries if the information appears to be incorrect, inconsistent, or incomplete. The return preparer must also keep a record of the reasonable inquiries made and the taxpayer’s responses to them.

**EXAMPLE:** Doris is 18 years old, earned $3,000 from a part-time job in 2016, and has a two-year old daughter. Doris tells you that she lived with her parents throughout the year, but she wants to claim her daughter as a qualifying child for the EITC. This information is incomplete and inconsistent because the taxpayer lived with her parents and earned very little income during the year. Under these circumstances, the return preparer should determine if the taxpayer herself is a dependent of her parents and, therefore, ineligible to claim the EITC.
The final due diligence requirement provides that the tax return preparer must retain certain records regarding the taxpayer's EITC claim for at least three years. There are three kinds of records that the return preparer must retain with respect to each taxpayer claiming the credit:

1. A copy of the completed Form 8867;
2. A copy of the completed Earned Income Credit Worksheet or other record of the preparer's EITC computation; and
3. A record of how the information was furnished, and who furnished the information used to complete Form 8867 and the Earned Income Credit Worksheet.

The return preparer may retain these items in either paper or electronic form, and must retain them for three years from the latest of the following dates: (1) the due date of the tax return (determined without regard to any extension); (2) the date the tax return or refund claim was filed in the case of a signing tax return preparer electronically filing the return or claim; (3) the date the tax return or refund claim was presented to the taxpayer for signature in the case of a signing tax return preparer who is not electronically filing the return or refund claim; or (4) the date the non-signing tax return preparer submitted to the signing tax return preparer that portion of the tax return or refund claim for which the non-signing tax return preparer was responsible.

**EXAMPLE:** Phil prepares the 2016 federal income tax return for Tammy that includes a claim for the EITC. Phil presents the return to Tammy on March 1, 2017, and it is electronically filed on March 31, 2017. Phil must retain the EITC documentation until at least April 15, 2020, because the due date of the return is April 15, 2017, which is the latest of the due date, presentation date, and filing date.

The PATH Act expands the paid-preparer due diligence requirements with respect to the EITC, and the associated $500 penalty for failures to comply, to cover returns claiming the child tax credit and American Opportunity Tax Credit, beginning with tax returns for periods ending after December 31, 2016.

**COMPLIANCE WITH E-FILE PROCEDURES**

Any return preparer who anticipates preparing and filing 11 or more Forms 1040, 1040A, 1040EZ and 1041 during a calendar year must use IRS e-file unless the preparer or a particular return is administratively exempt from the e-file requirement or the return is filed by a preparer with an approved hardship waiver. Members of firms must count returns in the aggregate for this purpose and if the number of applicable income tax returns is 11 or more, then all members of the firm generally must e-file the returns they prepare and file. This is true even if a particular firm member expects to prepare and file fewer than 11 returns on an individual basis. Note that a failure to electronically file a return when the preparer is required to do so is characterized as “disreputable conduct” under Circular 230.27

A preparer must be an authorized e-file provider to use IRS e-file. There are three steps to becoming an authorized e-file provider. First the preparer must create an IRS e-services account via the IRS website. Second, a comprehensive application must be submitted to the IRS after the preparer is approved for e-services. Finally, after submission of the application and related documents, the IRS will conduct a suitability check on the firm and each person listed on the application as either a principal or responsible official. This may include: a credit check; a tax compliance check; a criminal background check; and a check for prior non-compliance with IRS e-file requirements. Once

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27 Circular 230 ¶10.51(16).
approved, the IRS will issue an acceptance letter with an Electronic Filing Identification Number (“EFIN”). The authorization process generally takes about 45 days.

Notwithstanding these requirements, a taxpayer for whom a preparer prepares a return may choose instead to submit their own return to the IRS on paper. Preparers in this situation should obtain and keep a signed and dated statement from the client specifying the client’s desire and intent to do so. Also, in this situation and in the cases of administratively exempt returns or returns filed by a tax return preparer with an approved hardship waiver, the preparer should attach Form 8948, *Preparer Explanation for Not Filing Electronically*, to the client’s paper return.

Although hardship waivers are not frequently granted, a preparer may request an undue hardship waiver from the e-file requirement using Form 8944, *Preparer e-file Hardship Waiver Request*. Form 8944 must be submitted to the IRS no later than February 15 of the year for which a waiver is being requested.

**PENALTIES FOR NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS, AND FOR A WILLFUL UNDERSTATEMENT OF LIABILITY**

“Negligence” for the purpose of this penalty is defined as either: (1) any failure to make a reasonable attempt to comply with the provisions of the Code or (2) the careless, reckless, or intentional disregard of IRS rules or regulations. Negligence includes any failure to keep adequate books and records or to properly substantiate items on a tax return.

A disregard of rules or regulations is “careless” if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is not supported by relevant rule or regulation. A disregard is “reckless” if the taxpayer makes little or no effort to determine whether a rule or regulation exists. A disregard is “intentional” if the taxpayer actually knows that a particular rule or regulation requires a different position.

Note that the penalties for negligence and fraud are mutually exclusive; the penalty for negligence or disregard of rules or regulations will not be imposed on any portion of an underpayment on which the fraud penalty is imposed.

The ten most common indicators of negligence that will result in the assertion of this penalty are:

1. a history of noncompliance;
2. similar, prior audit results;
3. failure to keep adequate books and records;
4. inadequate internal controls for processing and reporting business transactions;
5. unreported or understated income, combined with the taxpayer’s failure to offer a reasonable explanation;
6. overstated deductions or credits, including claiming clearly improper or exaggerated amounts, unsubstantiated by facts or documentation;
7. using deduction descriptions in such a manner as to conceal the true nature of the deduction;
8. failure to explain items questioned by the IRS;
9. actions taken by the taxpayer to ensure that the return preparer did not have all the necessary and appropriate information to prepare a correct and/or timely return; and
10. information determined from cooperative state programs and state tax reports which
determined negligence for transactions having the same or similar federal and state tax
consequences.

A penalty of the greater of $5,000 or 75% of the income derived (or to be derived) by a tax return
preparer with respect to a return or claim is imposed if any part of an understatement of a
taxpayer's liability on a return or claim for refund is due to the preparer's willful attempt in any
manner to understate the taxpayer's tax liability or to any reckless or intentional disregard of rules
or regulations by the preparer. The amount of any penalty payable by a tax preparer because of a
willful understatement is reduced by the amount of the penalty paid by that preparer because of an
understatement due to an unreasonable position.

Willfulness is the “voluntary, intentional violation of a known legal duty” imposed by the Code. A
position is “unreasonable” unless there is or was substantial authority for it, except that: (1) if the
position is properly disclosed, the position is unreasonable unless there is a reasonable basis for it,
and (2) if the position is with respect to a reportable transaction or with respect to a tax shelter, the
position is unreasonable unless it is reasonable to believe that the position would more likely than
not be sustained on its merits.

“Substantial authority” is not well defined, but means something less than “more likely than not” and
something more than “reasonable basis.” The substantial authority standard is an objective
standard, so the taxpayer's subjective belief that there is substantial authority is not relevant in
determining whether the standard has been met. The eleven specified sources of authority that are
considered substantial for this purpose are the following:

1. The Code itself and other statutory provisions;
2. Treasury regulations (whether proposed, temporary or final);
3. Revenue rulings and revenue procedures;
4. Tax treaties and regulations thereunder, as well as official explanations of the Treasury
   Dept.;
5. Court cases;
6. Legislative history in the form of committee reports, joint explanatory statements of
   managers included in conference committee reports, and floor statements made prior to
   enactment by one of a bill's managers;
7. The General Explanations of tax legislation prepared by the Joint Committee on Taxation
   (commonly referred to as the Blue Book);
8. Private letter rulings and technical advice memoranda issued after October 31, 1976;
9. Actions on decisions and general counsel memoranda issued after March 12, 1981 and
general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin;
10. IRS information or press releases; and
11. Notices, announcements and other administrative materials published in the Internal
    Revenue Bulletin.

28 The penalty was increased from 50% to 75% by the PATH Act.
A substantial authority analysis is always an exercise in balancing. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, must be taken into account in determining whether substantial authority exists. A conclusion that there is substantial authority for the tax treatment of an item can be made only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

The weight of authorities is determined in light of the pertinent facts and circumstances. The weight accorded an authority depends on its relevance and persuasiveness, as well as the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. Likewise, an authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts.

The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action or decision generally must be accorded less weight than a more recent one. Any document that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document.

The analysis is not based on the volume of authority identified. There may be substantial authority for the tax treatment of an item despite the absence of multiple sources of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

Assuming there is substantial authority for a position and all the relevant forms and attachments are completed in a clear manner and in accordance with their instructions, additional disclosure is generally unnecessary for purposes of reducing any understatement of income tax under section 6662(d).

As noted above, except with respect to items attributable to tax shelters, if the taxpayer has a reasonable basis for the tax treatment of an item, the amount of the understatement is reduced by the portion with respect to which the relevant facts are adequately disclosed in the return or in a statement attached to the return.

To properly disclose the position, the taxpayer must complete and attach IRS Form 8275 to the tax return and disclose all relevant facts. If the position taken is contrary to a regulation, IRS Form 8275-R should be used. Note that Form 8275 disclosure is ineffective with respect to penalties for negligence, tax shelter items, substantial overstatement of pension liabilities, a substantial estate or gift tax valuation understatement, any claims of tax benefits from a transaction lacking economic substance, and any otherwise undisclosed foreign financial asset understatement.

To make adequate disclosure for items reported by a pass-through entity, the taxpayer must complete and file a separate Form 8275 as to each separate entity from which the items arise. Carryover and carryback items must be disclosed for the tax year in which they originated; they do not have to be reported on another Form 8275 for the tax years in which the carryover or carryback is taken into account.
While less stringent than the substantial authority standard, the reasonable basis standard is described in the regulations as a relatively high standard of tax reporting. The reasonable basis standard is significantly higher than “not frivolous” or “not patently improper.” It is not satisfied by a return position that is merely “arguable” or that sets forth merely a “colorable claim.” Instead, like substantial authority, a reasonable basis position must be based on one or more of the authorities set forth above, taking into account the relevance and persuasiveness of the authorities.

For purposes of determining whether the tax return preparer has a reasonable basis for a position, the preparer may rely in good faith without verification on information furnished by the taxpayer, as well as information and advice furnished by another advisor, another tax return preparer, or other party.

**ANNUAL FILING SEASON PROGRAM REQUIREMENTS**

Limited representation rights authorize a tax professional to represent a taxpayer if, and only if, the tax professional prepared and signed the return. The tax professional can only represent the taxpayer under these limited practice rights only before IRS revenue agents, customer service representatives and similar IRS employees. They cannot represent clients whose returns they did not prepare, and they cannot represent clients regarding appeals or collection issues even if they did prepare the return in question.

Effective for tax returns and claims for refunds prepared and signed after December 31, 2015, the limited right to represent clients before the IRS held by non-credentialed preparers will be accorded to only those preparers participating in the IRS Annual Filing Season Program. Thus, beginning in 2016, return preparers who are not attorneys, CPAs, or enrolled agents and do not participate in the Annual Filing Season Program will only be permitted to prepare tax returns, not to represent clients before the IRS (except in regard to returns they prepared before January 1, 2016).

The Annual Filing Season Program is a program of the IRS intended to recognize and encourage return preparers who are not attorneys, CPAs, or enrolled agents to voluntarily increase their knowledge and improve their filing season competency through continuing education. To participate in the Annual Filing Season Program an individual must have an active preparer tax identification number (“PTIN”) and take 18 hours of continuing education from IRS-approved continuing education (“CE”) providers. The continuing education courses taken must include: (1) a six hour Annual Federal Tax Refresher (“AFTR”) course that covers filing season issues and tax law updates, as well as a knowledge-based comprehension test administered at the end of the course by the CE provider; (2) ten hours of other federal tax law topics; and (3) two hours of ethics.

Additionally, the individual must consent to adhere to specific practice obligations outlined in Subpart B and section 10.51 of Circular 230. Those obligations are discussed in the next section. If the taxpayer has an online PTIN account, he or she will receive an e-mail from TaxPro_PTIN@irs.gov with instructions on how to sign the Circular 230 consent and receive a certificate in his or her online secure mailbox. For those who do not have an online PTIN account, they will receive a letter with instructions for completing the application process and obtaining the certificate.

**Adherence to Duties and Restrictions Found in Subpart B and Section 10.51 of Circular 230**

Subpart B of Circular 230 covers the duties and restrictions relating to practice before the IRS. This section highlights some of the provisions of Subpart B.
Responding to IRS Request for Information

A practitioner must, upon request, promptly submit records or information in any matter before the IRS unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged. If the requested records or information are not in the possession of the practitioner or the practitioner's client, the practitioner must promptly notify the requesting IRS officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information.

The practitioner must also make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons. Furthermore, a practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the IRS, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

Responsibilities When There is an Error on Return

A practitioner who, having been retained by a client with respect to a matter administered by the IRS, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

Due Diligence Requirements

Circular 230 requires that a practitioner exercise due diligence not only in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters, but also in determining the correctness of oral or written representations made by the practitioner to the IRS and in determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS. Generally, a practitioner will be presumed to have exercised due diligence if he or she relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

Practicing Before the IRS

Practitioners may not, knowingly and directly or indirectly accept assistance from or assist any person who is under disbarment or suspension from practice before the IRS if the assistance relates to a matter or matters constituting practice before the IRS.

Furthermore, no former government employee may, subsequent to government employment, represent anyone in any matter administered by the IRS if the representation would violate any laws of the United States. No former government employee who personally and substantially participated in a particular matter involving specific parties may, subsequent to government
employment, represent or knowingly assist, in that particular matter, any person who is or was a specific party to that particular matter.

A former government employee who, within a period of one year prior to the termination of government employment, had official responsibility for a particular matter involving specific parties may not, within two years after government employment is ended, represent in that particular matter any person who is or was a specific party to that particular matter.

No former government employee may, within one year after government employment is ended, communicate with or appear before, with the intent to influence, any employee of the Treasury Department in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule the development of which the former government employee participated in, or for which, within a period of one year prior to the termination of government employment, the former government employee had official responsibility. This does not, however, preclude any former employee from appearing on one’s own behalf or from representing a taxpayer before the IRS in connection with a particular matter involving specific parties involving the application or interpretation of a rule with respect to that particular matter, provided that the representation is otherwise consistent with the other provisions of this section and the former employee does not utilize or disclose any confidential information acquired by the former employee in the development of the rule.

Although many tax preparers are notaries, a practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the IRS and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

**Fees**

A practitioner may not charge an unconscionable fee in connection with any matter before the IRS. Circular 230 also prohibits a practitioner from charging a contingent fee for services rendered in connection with any matter before the IRS. However, in 2014 the U.S. District Court for the District of Columbia called into question the IRS’s ability to police return filing practice. The court in *Ridgely v. Lew*[^29] ruled that a CPA who prepares an original or amended return is not engaged in representation of taxpayers and thus is not engaged in practice subject to Circular 230. Thus, in the court’s opinion Circular 230 regulates CPAs, attorneys, and enrolled agents only when they are involved in examination or appeals representation. As a result, the court invalidated and permanently enjoined the IRS from prohibiting contingent fee arrangements for refund claims and amended returns. The IRS decided not to appeal that decision.

Even under the pre-Ridgely provisions of Circular 230, a practitioner was permitted to charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to an original tax return or an amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return. Furthermore, a practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS, as well as for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

**Client Records**

In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her federal tax obligations.

“Records of the client” for this purpose include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner’s representation of the client, that pre-existed the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner's firm, employees or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

**Conflicts of Interest**

A practitioner must not represent a client before the IRS if the representation involves a conflict of interest. A conflict of interest exists if either the representation of one client will be directly adverse to another client or there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

Notwithstanding the existence of a conflict of interest, the practitioner may represent a client if: (1) the practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; and (3) each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the IRS on request.

**Advertising**

A practitioner may not, with respect to any IRS matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive
statement or claim; or a misleading or deceptive statement or claim. Enrolled agents and enrolled retirement plan agents, in describing their professional designation, may not utilize the term “certified” or imply an employer/employee relationship with the IRS. Examples of acceptable descriptions for enrolled agents are “enrolled to represent taxpayers before the IRS,” “enrolled to practice before the IRS,” and “admitted to practice before the IRS.” Similarly, examples of acceptable descriptions for enrolled retirement plan agents are “enrolled to represent taxpayers before the IRS as a retirement plan agent” and “enrolled to practice before the IRS as a retirement plan agent.”

A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the IRS if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their state(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the IRS must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

Best Practices

Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the IRS. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:

1. Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

2. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

3. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

4. Acting fairly and with integrity in practice before the IRS.
Tax Returns

A practitioner may not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund, or advise a client to take a position on a return or claim for refund, that the practitioner knows or reasonably should know contains a position that: (1) lacks a reasonable basis; (2) is an unreasonable position; or (3) is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner.

A practitioner may not advise a client to submit a document, affidavit or other paper to the IRS the purpose of which is to delay or impede the administration of the federal tax laws; that is frivolous; or that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to a position taken on a tax return if the practitioner advised the client with respect to the position or the practitioner prepared or signed the tax return or any document, affidavit or other paper submitted to the IRS. The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the IRS, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

Competence

A practitioner must possess the necessary competence to engage in practice before the IRS. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

Requirements for Written Advice

A practitioner may give written advice (including by means of electronic communication) concerning one or more federal tax matters. Government submissions on matters of general policy are not considered written advice on a federal tax matter for this purpose. Continuing education presentations provided to an audience solely for the purpose of enhancing practitioners' professional knowledge on federal tax matters are not considered written advice on a federal tax matter for purposes of this section. The preceding sentence does not apply to presentations marketing or promoting transactions.

With respect to written advice the practitioner must—

1. Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);
2. Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;
3. Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;

4. Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable;

5. Relate applicable law and authorities to facts; and

6. Not, in evaluating a federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

Reliance on representations, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based are incorrect, incomplete, or inconsistent. A practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when—

1. The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;

2. The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or

3. The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part.

**Circular 230 Section 10.51**

Section 10.51 of Circular 230 covers actions that are considered incompetence or disreputable conduct. Circular 230 does not differentiate between the concepts of “incompetence” and “disreputable conduct,” but rather provides a laundry list of fifteen specific instances that fall under those general concepts. This list is intended to be illustrative rather than comprehensive and “disreputable conduct” is meant to include “any conduct that is violative of the ordinary standard of professional obligation and honor.” The list of incompetent or disreputable activities contained in section 10.51 of Circular 230 includes:

- Conviction of any criminal offense under federal tax law;
- Conviction of any criminal offense involving dishonesty or breach of trust;
- Conviction of a felony rendering the practitioner unfit to practice before the IRS;
- Giving false or misleading information to federal tax authorities;
- Indicating that special treatment can be obtained from the IRS;
- Willfully failing to file a federal return or pay federal taxes;
- Willfully assisting, counseling, encouraging the violation of federal tax law;
- Mishandling funds received from a client for the payment of taxes;
- Threats, false accusations, duress, coercion, or bribery of an IRS employee;
- Disbarment or suspension from practice by any state or by a federal agency;
- Knowingly assisting another who is suspended or disbarred from practice;
• Using abusive, malicious, or libelous language in a matter before the IRS;
• Inappropriate actions regarding the issuance of opinions;
• Willfully failing to sign a tax return prepared by the practitioner; and
• The inappropriate and willful disclosure or use of a tax information