

# TJAGSA Practice Notes

Faculty, The Judge Advocate General's School

## Tax Law Note

### Update for 2000 Federal Income Tax Returns

*The wisdom of man never yet contrived a system of taxation that would operate with perfect equality.*

Andrew Jackson<sup>1</sup>

*[A tax loophole is] something that benefits the other guy. If it benefits you, it is tax reform.*

United States Senator Russell B. Long<sup>2</sup>

For the past two years, the President and Congress have had a divergence of opinion on tax reform and legislation. The result has been a lack of comprehensive tax legislation since 1998. Therefore, most of the tax changes taking effect for 2000 are the effects of legislation from several years ago, annual adjustments for inflation, or regulatory changes by the Internal Revenue Service (IRS). The following article is a brief update of tax changes that are important for taxpayers in the military community. This article is not intended to serve as an in-depth review or explanation of each topic discussed. Rather, its intent is to inform legal assistance attorneys of updates in tax nomenclature and changes for the upcoming tax season.

## Key Changes for 2000

### Savings Bonds<sup>3</sup>

Since 1990, the Series EE US Savings Bonds have had an added feature that will allow owners to entirely exclude interest accrued on the bonds if used to pay for qualified educational expenses. There are four basic restrictions to the qualified Savings Bond exclusion program.<sup>4</sup> First, the exclusion is available only for bonds purchased on or after January 1, 1990.<sup>5</sup> Bonds purchased before this date will not qualify. Second, the bond must be issued to an individual who is at least twenty-four years old.<sup>6</sup> Third, the exclusion is phased-out as the adjusted gross income of the taxpayer exceeds certain levels depending on the owner's filing status.<sup>7</sup> Fourth, the amount of the interest on the redeemed bonds must be lower than qualified higher educational expenses of the child, the taxpayer, or a spouse.<sup>8</sup>

The limits are higher in 2000 for the exclusion of interest from income for Series EE Savings Bonds used for education.<sup>9</sup> The ability to exclude interest from savings bonds used for educational purposes phases out on joint returns beginning at a modified adjusted gross income of \$81,100 and ending at \$111,100 (\$79,650 to \$109,650 in 1999).<sup>10</sup> For single taxpayers the ability to exclude interest from savings bonds used for educational purposes begins at \$54,100 and terminates at \$69,100 (\$53,100 to \$68,100 in 1999).<sup>11</sup>

---

1. GERALD F. LIEBERMAN, 3,500 GOOD QUOTES FOR SPEAKERS (1983).

2. JAMES B. SIMPSON, SIMPSON'S CONTEMPORARY QUOTATIONS (1988).

3. For more information on the use of U.S. Savings Bonds for educational purposes, see I.R.S. Pub. 970, TAX BENEFITS FOR HIGHER EDUCATION (2000); ADMINISTRATIVE & CIVIL L. DEP'T, THE JUDGE ADVOCATE GENERAL'S SCHOOL, U.S. ARMY, JA 269, FEDERAL TAX INFORMATION SERIES (Dec. 2000) [hereinafter JA 269].

4. I.R.C. § 135 (LEXIS 2000).

5. *Id.* § 135(c)(1)(A).

6. *Id.* § 135 (c)(1)(B).

7. I.R.C. § 135(b)(2)(A).

8. *Id.* § 135(b)(1)(A).

9. *Id.*; Rev. Proc. 99-42, 1999-2 C.B. 568.

10. Rev. Proc. 99-42, 1999-2 C.B. 568.

11. *Id.*

### *Individual Retirement Arrangements (IRAs)*

More service members will be eligible to make deductible contributions to a traditional IRA for the 2000 tax year due to an increase in the phase-out limitations.<sup>12</sup> The phase-out limits for IRA deductions increase this year for employees covered by qualified retirement plans.<sup>13</sup> Because service members are active participants and have coverage by a pension or retirement plan, deductible IRA contributions are subject to limitations.<sup>14</sup> The adjusted gross income (AGI) limits are gradually increasing over the next several years. For 2000, married filing jointly, the phase-out begins at \$52,000 and tops out at \$62,000.<sup>15</sup> In 2007 and thereafter the maximum range will be from \$80,000 to \$100,000.<sup>16</sup> For single filers (including head of household), the phase-out begins at \$32,000 and ends at \$42,000.<sup>17</sup> In 2005 and thereafter the maximum range will be from \$50,000 to \$60,000.<sup>18</sup> For married filing separately, the limit remains \$10,000.<sup>19</sup>

New regulations became effective in 2000 that limit tax-saving ploys of investors who convert traditional IRAs to Roth IRAs.<sup>20</sup> The intent of the new regulations is to close a loophole in the tax law where investors could undo Roth IRA conversions and then redo them simply to lower their tax bill. Before 2000, taxpayers converting to a Roth IRA could later undo the conversion by rolling the money back into a traditional IRA and then immediately reconvert back to a Roth IRA. The redoing of a Roth IRA conversion was a lucrative tax-saving move if the value of an IRA had dropped since the time of the conversion because the funds converted to a Roth IRA are subject to tax based on the value of the assets at the time of the conver-

sion. If the conversion of a Roth IRA was performed when the value decreased, then the taxpayer paid tax on the lower value. By redoing a Roth conversion, the investor could take advantage of a downturn in stock prices to reduce the tax bite on a Roth conversion. There are now more restrictions on reconverting a traditional or regular IRA back to a Roth IRA. Beginning in 2000, taxpayers that convert to a Roth IRA will have to wait until the next tax year following the conversion to reconvert. In addition, the regulations require a minimum thirty day waiting period between the time the taxpayer undoes a Roth IRA conversion and conversion back to a Roth IRA.<sup>21</sup>

### *Student Loan Interest Deduction*

The student loan interest deduction is more valuable for tax-year 2000.<sup>22</sup> For 2000, taxpayers can deduct up to \$2000 of student loan interest and in 2001 the amount increases to \$2500 (was \$1500 in 1999).<sup>23</sup> The Student Loan Interest Deduction is not an itemized deduction, and taxpayers do not have to itemize to qualify for this deduction. However, the deduction declines for couples with an adjusted gross income of \$60,000 to \$75,000. For single taxpayers, the deduction decreases with an adjusted gross income of \$40,000 to \$55,000.<sup>24</sup>

### *Household Employment ("Nanny") Tax<sup>25</sup>*

If a taxpayer pays a housekeeper or household helper less than \$1200 in 2000, the taxpayer will not have to pay Social Security or Medicare taxes on behalf of the employee.<sup>26</sup> The

12. I.R.C. § 219(g). For more information on IRAs in general, see I.R.S. Pub. 590, *INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs)* (2000); JA 269, *supra* note 3, at 28-37.

13. Rev. Proc. 99-42, 1999-2 C.B. 568.

14. I.R.C. 219(g); I.R.S. Notice 87-16, 1987-1 C.B. 446; *Morales-Caban v. Commissioner*, 66 T.C.M. (CCH) 995 (1993).

15. I.R.C. § 219(g)(2)(A)(ii).

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. Treas. Reg. § 1.408A-5 (2000).

21. *Id.*

22. For more information on the Student Loan Interest Deduction, see Major Richard Rousseau, TJAGSA Practice Notes, *Internal Revenue Service Restructuring and Reform Act of 1998*, ARMY LAW., Nov. 1998, at 40-41; Major Richard Rousseau, TJAGSA Practice Notes, *Update for 1998 Federal Income Tax Returns*, ARMY LAW., Nov. 1998, at 44-45; Major Richard Rousseau, TJAGSA Practice Notes, *Update for 1999 Federal Income Tax Returns*, ARMY LAW., Dec. 1999, at 30.

23. I.R.C. § 221(b)(1).

24. I.R.C. § 221(b)(1)(B).

25. For more information on the taxation of household employees, see I.R.S. Pub. 926 *HOUSEHOLD EMPLOYER'S TAX GUIDE FOR WAGES PAID IN 2000* (2000).

threshold is up from \$1100 in 1999. The “Nanny tax” threshold will increase to \$1300 for 2001. The threshold is adjusted for inflation each year based on increases in average wages.<sup>27</sup> However, the federal unemployment tax (FUTA) limit for household employees does not change because this tax is not indexed for inflation. The FUTA applies whenever a domestic employee is paid \$1000 or more in a calendar quarter in the current or prior tax year.

### *Earned Income Credit (EIC)*<sup>28</sup>

The refundable EIC is available to certain low-income individuals who have earned income, meet adjusted gross income thresholds, and do not have more than a certain amount of disqualified income.<sup>29</sup> Beginning in 2000, the EIC is denied if the aggregate amount of disqualified income exceeds \$2400 (\$2350 in 1999).<sup>30</sup>

Those who seek to include eligible foster children in their households for purposes of the EIC face additional requirements. Previously, a child was an eligible foster child for the EIC if the taxpayer cared for the child as they would their own child and the child lived with the taxpayer for the whole year (except for temporary absences). Beginning in 2000, in addition to the prior rules mentioned, the child must be a brother, sister, stepbrother, or stepsister (or a descendant of your brother, sister, stepbrother, or stepsister) or have been placed with the taxpayer by an authorized placement agency.<sup>31</sup>

### *Tax Form Changes*

The Alternative Minimum Tax (AMT) line (Form 1040, line 51 (1999)) has moved to a different section on the tax form

(Form 1040, line 41 (2000)). For 2000, the AMT line appears after the line for calculating the regular tax instead of in the section for other taxes. The change is designed to simplify the AMT calculation of the offset for personal credits for dependent care, education, and the child tax credit.

Beginning in 2000, certain capital gain distributions may be reported on line 10 of IRS Form 1040A. Because of this change, there is a conflict with the “Caution” included in the instructions on the back of Copy B of the 2000 Form 1099-DIV. The caution tells recipients if there is an amount in box 2a (total capital gain distributions), they must file Form 1040 and cannot use Form 1040A. However, because of the addition of line 10 on the 2000 Form 1040A, a recipient of Form 1099-DIV with an amount in box 2a may be able to file Form 1040A. In addition, for 2000, the instructions for Form 1040A will contain a Capital Gain Tax Worksheet to figure the tax. The worksheet is similar to the one in the 1999 Form 1040 instructions.

Near the end of the tax forms (1040EZ, 1040A, 1040), there is a new checkbox to give permission to the IRS to talk to the tax return preparer and bypass the individual tax filer to discuss questions or issues regarding processing related matters on the returns.<sup>32</sup> In the past, tax practitioners (attorneys, CPAs, and enrolled agents) and other paid preparers needed a power of attorney in order to discuss tax return preparation, refunds, and payment issues with the IRS. Under this new option, the taxpayer’s designee has the ability to speak directly to the IRS Customer Service representatives over the telephone and in person in response to math error notices or to receive information about a refund or payment.<sup>33</sup> Each military tax assistance program will have to decide whether to use this new checkbox. However, military tax assistance programs need to keep in mind that the IRS could attempt to contact a military tax preparer several years after the filing of the tax return. Many mil-

26. I.R.C. §§ 3121(a)(7)(B), 3121(x).

27. Section 2 of the Social Security Domestic Employment Reform Act of 1994 increased the threshold for coverage of a domestic employee’s wages paid per employer from \$50 per calendar quarter to \$1000 per annum in calendar year 1994. Pub. L. No. 103-387, 108 Stat. 4071. The statute held the coverage threshold at the \$1000 level for 1995 and then increased the threshold in \$100 increments for years after 1995. Section 3121(x) of the Internal Revenue Code provides the formula for increasing the threshold. Under the formula, the domestic employee coverage threshold amount for 2000 shall be equal to the 1995 amount of \$1000 multiplied by the ratio of the national average wage index for 1998 to that for 1993. If the amount so determined is not a multiple of \$100, it shall be rounded to the next lower multiple of \$100. The ratio of the national average wage index for 1998, \$ 28,861.44, compared to that for 1993, \$ 23,132.67, is 1.2476485. Multiplying the 1995 domestic employee coverage threshold amount of \$1000 by the ratio of 1.2476485 produces the amount of \$1247.65, which must then be rounded to \$1,200. Accordingly, the domestic employee coverage threshold amount is determined to be \$1200 for 2000. 64 Fed. Reg. 57,506-512 (Oct. 20, 1999).

28. I.R.C. § 32. For more information on the Earned Income Credit, see I.R.S. Pub. 596, EARNED INCOME CREDIT (2000).

29. I.R.C. §§ 32(a), 32(i). Disqualified income includes an individual’s capital gain net income and net passive income in addition to interest, dividends, tax-exempt interest, and non-business rents or royalties. *Id.*

30. I.R.C. § 32(j)(1); Rev. Proc. 99-42, 1999-2 C.B. 568.

31. I.R.C. § 32(c)(3)(B)(iii).

32. I.R.S. Pub. 17, YOUR FEDERAL INCOME TAX (2000).

33. *Id.* It should be noted that the authorization cannot be revoked by the taxpayer. Nevertheless, the authorization will automatically end no later than the due date (without regard to extensions) for filing a 2001 tax return.

itary tax assistance programs are only seasonal operations and only a few maintain the same personnel from year to year. Therefore, most military tax assistance programs may not want to check the box.

*Mailing Locations for Tax Returns*

Some taxpayers will mail their tax returns to a different IRS Service Center this year because the IRS changed the filing location for several areas. Taxpayers should mail tax returns to the address on the envelope received with their tax package, or note the proper mailing address in the Form 1040 Instruction Booklet. Major Rousseau.

## 2000 Numerology<sup>34</sup>

### Tax Rates

The 2000 federal income tax rates are: 15%, 28%, 31%, 36%, and 39.6% .

The 2000 tax rates by filing status are:

#### Married Filing Jointly and Qualifying Widow(er):

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 43,850	15%
43,850 - 105,950	28%
105,950 - 161,450	31%
161,450 - 288,350	36%
over 288,350	39.6%

#### Single:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 26,250	15%
26,250 - 63,550	28%
63,550 - 132,600	31%
132,600 - 288,350	36%
over 288,350	39.6%

#### Head of Household:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$0 - 35,150	15%
35,150 - 90,800	28%
90,800 - 147,050	31%
147,050 - 288,350	36%
over 288,350	39.6%

#### Married Filing Separately:

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 21,925	15%
21,925 - 52,975	28%
52,975 - 80,725	31%
80,725 - 144,175	36%
over 144,175	39.6%

---

34. Rev. Proc. 99-42, 1992-2 C.B. 568.

*Estates and Trusts:*

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>
\$1 - 1750	15%
1750 - 4150	28%
4150 - 6300	31%
6300 - 8650	36%
over 8650	39.6%

*Standard Deduction*

Married filing jointly or qualifying widow(er) - \$7350 (\$7200 in 1999; Projected for 2001 \$7600).

Single - \$4400 (\$4300 in 1999; Projected for 2001 \$4550).

Head of household - \$6450 (\$6350 in 1999; Projected for 2001 \$6650).

Married filing separately - \$3675 (\$3600 in 1999).

*Reduction of Itemized Deductions*

Otherwise allowable itemized deductions are reduced if AGI in 2000 exceeds:

Married filing separately - \$64,475.

All other returns - \$128,950.

*Personal Exemptions*

Personal exemption deduction - \$2800 (\$2750 in 1999; Projected for 2001 \$2900).

Phase Out of Personal Exemptions:

<u>Taxpayer</u>	<u>Begins After</u>
Married filing jointly	\$193,400
Single	\$128,950
Head of household	\$161,150
Married filing separately	\$ 96,700

*Foreign Earned Income Exclusion<sup>35</sup>*

Higher exclusion for 2000: \$76,000 (was \$74,000 in 1999; will be \$78,000 in 2001; and \$80,000 in 2002 and thereafter.<sup>36</sup>

---

35. I.R.C. § 911. For more information on Foreign Earned Income Exclusion see I.R.S. Pub. 54, TAX GUIDE FOR U.S. CITIZENS AND RESIDENT ALIENS ABROAD (2000); I.R.S. Pub. 516, TAX INFORMATION FOR U.S. GOVERNMENT CIVILIAN EMPLOYEES STATIONED ABROAD (2000); I.R.S. Pub. 593, INCOME TAX BENEFITS FOR CITIZENS WHO GO OVERSEAS (2000); JA 269, *supra* note 3, at 64-70.

36. I.R.C. § 911(b).

*Earned Income Credit*

Number of Children	Maximum Amount of the Credit	Earned Income Amount	Threshold Phaseout Amount	Completed Phaseout Amount
1	\$2353	\$6920	\$12,690	\$27,413
2	\$3888	\$9720	\$12,690	\$31,152
None	\$353	\$4610	\$5,770	\$10,380

*Auto Standard Mileage Allowances*

If a taxpayer can use an automobile for business, medical, charity, and/or moving purposes, the taxpayer is allowed a standard mileage deduction rate. For 2000, the rates are:

Business: 32.5 cents per mile.

Charity: 14 cents per mile.

Medical or Moving: 10 cents per mile.