# Assisting Low Income Taxpayers

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by Peter James Lingane, EA, CFP®, NTPI[F]

Peter's Lafayette, California practice emphasizes planning and compliance for individuals, trusts and estates. He has volunteered with low income tax assistance programs since 1994. Peter can be reached at peter@lingane.com or at (925) 299-0472.

**Summary**. The return of a low income taxpayer presents two primary challenges.

- The interview is of heightened importance because there is no ongoing relationship and because of prejudices on the part of both the taxpayer and preparer.
- Tax complexity. This will be illustrated by a series of vignettes involving foster children and new immigrants. The vignettes are based on the author's experiences as an AARP-Tax Aide volunteer[1] in Oakland, California.

These challenges illustrate the need for more participation by tax professionals. Participation is limited by the perception that the low income programs compete with paid preparers. Professionals are also dissuaded by the focus on the Spring filing season, by computer-related issues and by the absence of mechanisms whereby professionals could provide *ad hoc* assistance.

The primary benefit from assisting low income taxpayers is the personal satisfaction derived from helping others. But technical challenges make volunteering fun. And CPE credit is available.

**The Interview**. A preparer usually knows a great deal about a returning client. Prior returns are available and often workpapers as well. As a result, there may be no need for a formal interview if the questions in the "organizer" have been answered completely and if the taxpayer has provided the appropriate documentation. Low income taxpayers seldom establish an ongoing relationship with a preparer and thus the taxpayer interview must usually start from scratch.

An interviewer's first task is to gain the taxpayer's confidence. This is especially important when dealing with low income taxpayers since they generally know nothing

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[1] AARP-Tax Aide is the largest of the Tax Counseling for the Elderly (TCE) grantees. It has about thirty thousand volunteers, assists more than 1.7 million taxpayers annually and e-files more than 180,000 returns. The program is available to taxpayers with middle and low income with special attention to those aged sixty and older. Program costs are shared between the AARP Foundation and the IRS. Local sponsors provide additional assistance. (Source: *2001 Annual Report of the AARP Foundation* at www.aarp.org/foundation/01annrpt.pdf.)

The IRS also sponsors the Volunteer Income Tax Assistance (VITA) program. The TCE/VITA programs have a total of about seventy thousand volunteers and assist 3.5 million taxpayers. (Source: *2001 Volunteer's Assister Guide*, Publication 1155, Internal Revenue Service.)

Unofficial statistics suggest that these programs experienced a big increase in e-filed returns last Spring.

The author's experiences may not be representative of the low income assistance programs and his opinions may not represent the views of the program sponsors or of the individuals mentioned herein.

 

about the preparer in front of them but they do know that the size of their refund depends on how the return is prepared.

It is not uncommon for the taxpayer to try to get things moving in what they think is the right direction by announcing something like "I'm Head of Household and I've got three dependents and I got three thousand back last year."

It is easy to be intimidated by such declarations but the experienced interviewer knows that it is their job to manage the interview so as to get the information needed to prepare an accurate return.

This low income mother is probably not telling the whole story. There is almost certainly other income or another earner in the household. I dread this presentation because an accurate return means intrusive questioning of the taxpayer and the result may not live up to her expectations of how the return should be prepared.

But perhaps it is not necessary to dot ever i and cross every t. Must the return be accurate in every detail if filing "Head of Household with three dependents" results in the same tax liability? That's something each preparer must decide for themselves.

The taxpayer's preconceived notions can increase their tax liability. A elderly woman informed me rather tartly that "The distribution from my limited partnership goes on Schedule B, just like the volunteer did last year." I suppressed my instinctive response and insisted that she go home and find the partnership's K-1. I got to amend three returns for my trouble and I earned this woman's undying gratitude.

It is hard to escape the suspicion that an answer is sometimes influenced by the effect that the response has on the amount of the refund. For this reason, the experienced interviewer will have developed techniques to elicit information without it being obvious why a question is being asked. Apparently innocuous small talk about the difficulty in finding reasonably priced accommodations or day care arrangements may elicit information about the taxpayer's household which a direct question might not.

Marital status is an area where I encounter inaccurate responses with some frequency. I have had better luck asking 'Have you ever been married?" than I have had asking "Are you married?" If the response is "No." or if the taxpayer explains that their spouse died or that they were divorced some years ago, this strategy does not gain additional information.

But it is not uncommon for the response to be "Yes, but I file as Single

- "because he disappeared years ago."
- "because my spouse's only income is Social Security."
- "because my spouse does not live in this country."

in which case the interviewer has learned that they need to determine the appropriate filing status. When the response is "Yes, but we are separated" or "Yes, but I got a divorce last year," the interviewer has learned that they need to address the allocation of community income and that they may not be able to prepare the return without information from both spouses.

An interviewer has their own prejudices and the challenge is to not let these prejudices influence the questioning. I get a lot of quizzical looks because I've made it a habit to

ask everyone "Are you age sixty five or older?" But I suffer these looks because of the working woman who appeared middle-aged and whose response was "Young man, I'm eighty two!"

Who would have thought that a low income cook with limited English skills would have had a thousand dollars in interest income! Or that a student would have owned, let alone sold, a multiunit apartment building in South America!

A comprehensive interview is better than a quick interview. A comprehensive interviewer means testing each section of the Form 1040, even topics about which the interviewer only knows enough to ask a question. The experienced interviewer learns to ask questions in a priority order, focusing first on determining whether a tax return is required or might be required. The experienced interviewer also considers materiality and tailors the subsequent questions accordingly.

The experienced interviewer focuses on the things that the computer does not know. If a W-2 is missed, the document matching program will pick it up. But if the interviewer gets the filing status wrong, no one will know unless the return is audited.

An interviewer needs to manage their own anxieties. My fear is that I will misapply some rule. (As a volunteer at the Oakland Main Library, I don't have a computer to stop me from doing something dumb.) My solution is to bookmark specific topics and diagrams in Publication 17 and to check the rules with every taxpayer.

Pretending to look something up is a good ploy when you need a couple of seconds to evaluate what you are being told. Looking things up can also be used to deflect the taxpayer's disappointment. After all, you were ready to give the taxpayer the Earned Income Tax Credit (or whatever) but the chart says she does not qualify.

Conclude with an open ended question like "Did anyone pay you for something that we have not talked about?" It was a question like this that surfaced the sale of the South American apartment building.

The IRS's *Volunteer Assister's Guide* and the FTB's *California Volunteer Reference Manual* are the training guides for the TCE/VITA programs. They run to hundreds of pages but devote less than two pages to interviewing. To correct this deficiency, I spend an hour discussing interviewing with the Oakland volunteers[2]. I also advise the volunteers that a taxpayer need not amend a return if they discover an honest error.

**Foster Children**. Consider the following vignette.

| Jack and Jill are unmarried and they share their home with Jill's child. Jill has some income but Jack is the primary breadwinner. Who may claim the child as a dependent? |
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The child is Jack's dependent because Jack provides more than half of the child's support and because the child lives with Jack for the entire year[3]. It is immaterial whether the child is also Jack's foster child.

| Who is entitled to claim the child for the Earned Income Tax Credit (EITC)? |
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[2] See www.lingane.com/tax/seminars/interview.pdf for the handout used in this training.

[3] IRC §152(a)(9)

To qualify for the EITC, a taxpayer must have a Social Security card which allows employment. The taxpayer cannot be a non resident alien, cannot be Married Filing Separately and cannot be excluding foreign income. There are limitations on both earned and investment income[4]. The taxpayer must be between the ages of 25 and 64 unless a "qualifying child" lives with the taxpayer for more than half of the year. A qualifying child must generally be less than age 19 but need not be a dependent.

The child is Jill's qualifying child. The child is also, potentially, Jack's qualifying child or more precisely Jack's qualifying "foster child." Thus we have a potential competition for the same qualifying child. The tie-breaker rule was that the taxpayer with the higher AGI got to claim the EITC. The new tie-breaker rule, as revised for 2002, is that the parent gets priority[5].

But we don't have to get into breaking ties. This child is not Jack's foster child for EITC purposes because she was not placed in the home by an authorized agency[6].

## May Jack or Jill file as Head of Household?

To file as head of household[7],

1. An individual must be unmarried as of the end of his taxable year. An individual is considered unmarried when determining filing status if
   - They were never married.
   - They are divorced or legally separated under a decree of separate maintenance.
   - They are married to a non resident alien.

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[4] Beginning in 2002, earned income means taxable earned income. Cf. IRC §32(c)(2)(A)(i). It is no longer necessary to adjust earned income for elective deferrals to a 401(k) pension, for example.

It is no longer necessary to adjust or modify the AGI. Cf. IRC §32(a)(2)(B).

The limit on taxable and non taxable interest and dividends is $2,550. IRC §32(i); Rev. Proc. 2001-59.

Separate, slightly more generous tables will apply for married taxpayers. Cf. IRC §32(b)(2).

[5] IRC §32(c)(1)(C). 2 or more claiming qualifying child.

(i) In general. Except as provided in clause (ii), if (but for this paragraph) an individual may be claimed, and is claimed, as a qualifying child by 2 or more taxpayers for a taxable year beginning in the same calendar year, such individual shall be treated as the qualifying child of the taxpayer who is—

(I) a parent of the individual, or

(II) if subclause (I) does not apply, the taxpayer with the highest adjusted gross income for such taxable year.

(ii) More than 1 claiming credit. If the parents claiming the credit with respect to any qualifying child do not file a joint return together, such child shall be treated as the qualifying child of—

(I) the parent with whom the child resided for the longest period of time during the taxable year, or

(II) if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income.

[6] IRC §32(c)(3)(B)(iii).

[7] IRC §2(b).

- They live apart from their spouse for the last six months of the year, file a separate tax return and otherwise meet the requirements for head of household status based on a child who is their dependent.

2. You can't claim Head of Household status if you can file as a Qualifying Widow(er) or Married Filing Jointly with a deceased spouse.
3. A Head of Household filer cannot be a non resident alien.
4. The individual must provide more than half of the cost of keeping up a home.

   The home can be the taxpayer's home if the home is also, for more than half of the taxable year, the principal abode of the taxpayer's child or qualifying relative.

   The home can be the home of a parent if the home is the parent's principal abode for the entire year and if the parent is the taxpayer's dependent.

   A child is the taxpayer's son or daughter, or stepson or stepdaughter, or adopted son or daughter, or the descendant of a son or daughter, or foster child[8].

   Generally, a qualifying child does not need to be a dependent. However, a qualifying married[9] or foster child or a qualifying relative must be a dependent.

Jill cannot file as Head of Household because she does not provide more than half of the cost of the home. Jack can file as Head of Household if Jane is his foster child.

The federal definition of foster child appears in the regulations. The child must be the taxpayer's dependent and

> A "foster child" is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child[10].

The U.S. Tax Court held, in the same facts as the Jack and Jill scenario, that Jack is entitled to Head of Household status[11].

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[8] Rev. Rul. 84-89. This ruling addressed the conditions under which a foster child qualifies someone as Head of Household but it did not address the definition of "foster child."

A Revenue Ruling is an interpretation of the IRC and its regulations. It is binding on the IRS but can be challenged (usually unsuccessfully) by a taxpayer.

[9] A married child is a qualifying child if they would be a dependent except that the dependency exemption has been released to the non custodial parent by a Form 8332 or by a pre-1985 written agreement.

[10] Regulation §1.152-2(c)(4). "For purposes of determining the existence of any of the relationships specified in section 152(a) or (b)(1), a foster child of an individual (if such foster child satisfies the requirements set forth in paragraph (b) of §1.152-1 with respect to such individual) shall, for taxable years beginning after December 31, 1969, be treated as a child of such individual by blood. For purposes of this subparagraph, a foster child is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child. Status as a foster child is not dependent upon or affected by the circumstances under which the child became a member of the household."

A definition in a regulation discussing the dependency exemption is relevant to Head of Household status because a youngster is not a qualifying child for Head of Household status if §152(a)(9) applies and this section applies unless the youngster is a foster child for purposes of the dependency exemption.

[11] Samuel K. Rasco v. Commissioner, TC Memo 1999-169, May 18, 1999, relating to the 1995 tax year.

The case originated from Nevada. The judge knew that the mother lived in the same household but he did not address the implications of the mother's presence.

The California State Board of Equalization (SBE) has refined the federal definition[12].

> A foster child is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child[13].
>
> The foster relationship with the individual must have begun while the individual was a minor (i.e., under the age of 18)[14].
>
> The circumstances under which the child became a member of the household does not affect his or her status as a foster child[15].
>
> A foster child is considered your child by blood if you are entitled to a dependent exemption for the child, your home was the main home of the child for the entire year, and the child's parent did not live in your home[16].
>
> However, if a government or a tax-exempt child placement agency makes payment to you as a foster parent, the child cannot be claimed as your dependent and you will not qualify for the head of household filing status on the basis of this child[17]
>
> If a child who was not your own child lived with you, and at the same time the child's parent lived with you; the child cannot be considered your foster child. Such a child cannot qualify you for the head of household filing status, even if the child lived with you during the entire year, you paid all of the household expenses, and you paid all of the child's support.

The FTB sends Form 1540e to a substantial fraction of the Head of Household filers. This questionnaire asks whether the child's parent lives in the household and the FTB routinely disallows Head of Household status the child's parent lives in the household.

Jack should not play audit roulette unless he is prepared to appeal the disallowance of this filing status. Such an appeal will fail absent new arguments or extenuating facts[18]. Low income taxpayers do not have the resources to contest the California definition of foster child. Jack should file as "Single" on his California return.

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[12] Downloaded from www.ftb.ca.gov/hoh/selftest/definitions.html#12. Citations were added by the author.

[13] Reg. 1.152-2(c)(4) *op. cit*. The Board interprets this to mean that the child "is removed from his parents." See *Appeal of Curtis* (97-SBE-012) and *Appeal of Halvas* (97-SBE-013). These cases relate to 1993 and 1994 respectively.

The *Appeal of Tierney* (97-SBE-006a) and the *Appeal of Godek* (98-SBE-006) concluded that a parent may include one half of the time during which spouses or ex-spouses occupied the same household for purposes of determining their child's principal place of abode for more than one-half of the year.

The more important Board decisions are available at http://www.boe.ca.gov/legal/legalopcont.htm.

[14] *Appeal of Lobo* (99-SBE-001). Taxes would be a mite less complex if the Board had said "The answer should be under age 18 but we will use under age 19 for consistency with the dependency exemption."

[15] IRS Reg. 1.152-2(c)(4).

[16] The dependency and one year requirements are mandated by IRC §152(c). For the requirement that the child's parent not live in the same household, see footnote 13.

[17] It is unclear why the agency's payment invalidates the foster relationship if the taxpayer provides more than half of the total support.

[18] In the *Appeal of Curtis* (97-SBE-012), the Board wrote "In fact, in 1993 Steven's mother also lived in appellant's home, and we believe it was she who 'cared' for 19 year old Steven during 1993." This

Must Jack use the same filing status on his federal and California returns?

Typically, the IRS will look to local law for the definition of family relationships and the IRS would be within its rights to deny Jack Head of Household status on his federal return by virtue of California's definition of foster child. However, the IRS is only required to use the state's definition when it is enshrined in statue or sanctioned by the state's highest court. The IRS is not bound by a SBE definition.

If I were Jack, I would be prepared to argue that the Treasury regulation should be interpreted to include situations where the child is in the joint care of both the parent and the non parent and I would prepare the return accordingly.

A situation where the primary breadwinner, a child and the child's parent reside in the same household is one of those relatively rare instances[19] when it is permissible to prepare the California and federal returns with different filing statuses.

As tax professionals, we know that the proper tax treatment is often influenced by the facts and circumstances. Further, as Enrolled Agents, we see the preparer as the taxpayer's advocate when the decision is not clear cut. I'd like to see these points included in the official training materials for the low income assistance programs

**Turning Immigrants into Residents**. Residents and non residents are taxed by different rules. Oakland is a city of immigrants. Some will be taxed as residents because they have been here for years. (Some immigrants may have become citizens but both citizens and residents are taxed by the same rules.) Some will be non residents and others will have become residents during the current tax year.

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phrasing suggests that the Board might have reached a different decision if the facts had shown the non parent to be the primary care giver. The parent might be ill, for example.

The *Appeal of Hisserich* (99-SBE-002) also suggests that the Board is willing to reconsider given extenuating facts. In *Hisserich*, the Board interpreted "daughter" to include the child of a woman's registered domestic partner in the special circumstances where the taxpayer "intended from the outset to be Madaline's parent and continued to exhibit her intent to parent after Madeline's birth, that Madeline otherwise qualifies as a qualified individual under the head of household rules, and that no one else can claim Madeline as a dependent." The Sacramento Superior Court (*Proposition 22 Legal Defense Fund vs. California State BOE and FTB*, Case 01CS00718, Sept 14, 2001) ruled that this interpretation is outside the scope of Rev & Tax "17042, is unauthorized by relevant statutory and case law, and therefore is invalid" and that *Hisserich* cannot be cited as precedent for other taxpayers with similar facts.

The normal procedure to appeal a SBE decision is to pay the assessment and to then file a claim for refund. The FTB would deny this claim and this denial provides the basis for an appeal. The *Appeal of Hisserich* broke new ground because this was the first time that a judge had ruled that a court had jurisdiction to review a SBE decision other than a refund claim. This case is also important in that the suit was brought by a third party, in a sort of citizen's arrest, and this had not happened previously either.

[19] Rev & Tax §18521(a)(1) Except as otherwise provided in this section, an individual shall use the same filing status that he or she used on his or her federal income tax return filed for the same taxable year.

However, the "correct" status must be used on the California return if the status on the federal return is "incorrect." Rev & Tax §18521(a)(2) If the Franchise Tax Board determines that the filing status used on the taxpayer's federal income tax return was incorrect, the Franchise Tax Board may, under Section 19033 (relating to deficiency assessments), revise the return to reflect a correct filing status.

The California Codes are available on-line at http://www.leginfo.ca.gov/calaw.html.

It is usually better for a low income immigrant to be taxed as a resident. It is also better from a tax preparation standpoint since few preparers see enough non residents to become proficient in this specialized arena. This section addresses the elections which allow some non residents to be taxed as residents. Additional detail is provided in the appendix.

Let's start with California. Almost everyone who lives in California for more than a few months is a California resident. Immigrants are generally considered California residents from the day that they arrive in the U.S. New immigrants are generally part-year residents in the year of entry. They file Form 540NR if worldwide gross income is above the California filing threshold and the tax is based on the ratio of income while a California resident to worldwide income. This is exactly the same rule as for a U.S. citizen moving to California from another state.

In subsequent years, immigrants file Form 540 if worldwide gross income is above the California filing threshold and the tax is based on their worldwide income.

The low income assistance programs do not train in the preparation of part-year returns since there are usually several state returns involved. This limitation doesn't affect low income immigrants since they seldom have a California filing requirement.

Things are more complex on the federal side. One can be a U.S. resident by virtue of having been issued a green card. Others become U.S. residents by living here for six to twelve months, even if their status is undocumented. A non resident who is married to a U.S. resident (or citizen) can elect to be treated as a U.S. resident.

The interviewer might start by asking "Did you live in California for the entire year?" A positive response will generally rule out both a California part-year return and a federal non resident return. However, some visitors, notably students and Canadian and Mexican citizens, can live in the U.S. for years without be being treated as a resident.

Determining residency is discussed in detail in the appendix. The rules can be complex. Consider the following vignette.

A woman entered the U.S. in October 1999 on an F-1 student visa. She had left a husband and three children at home in Mongolia, which is an independent nation of 2.5 million sandwiched between Russia and China. Her husband, also a student, joined her in February 2001. They worked at every job they could find because "we are from a poor country." She earned $12,000 and her husband $4,000 during 2001.

What is the residency status of this woman and of her husband?

A student is generally a non resident. However, this assumes that the student doesn't over stay their visa and that they don't accept unauthorized unemployment. Since this student worked more than the four hours per week authorized by the INS, she had violated her visa and, since she has been in the U.S. long enough, she is taxed as a resident. Her husband may or may not be a resident as of the end of the year but in either event he can elect[20] to be treated as a resident since his wife is a resident.

[20] The election is made under IRC §6013(g) if the husband is a non resident and under §6013(h) if the husband is a resident as of the end of the year. See Publication 519, Chapter 1. For utmost clarity, read the Code.

Being taxed as a resident is attractive for low income individuals because they are otherwise denied the Earned Income Credit, the standard deduction and exemptions for their children who accompany them to the U.S. In addition, non resident aliens are prevented from filing as Head of Household or Married Filing Jointly.

Because this woman violated her visa, she and her husband are treated as residents and their tax liability is less. A happy result. More cynically, crime does pay!

The non resident husband was allowed to elect to be treated as a resident because he was married to a U.S. resident or citizen. What about the prior year, before the husband came to the U.S.? The answer is that the election is available to married couples even if the non resident spouse has never been to the U.S.

The taxpayer earned $12,000. He is married and he hopes that his wife, who lives in Ethiopia, will be able to join him in the U.S. one day. His daughter is enrolled at a community college. The daughter has a part-time job and usually stays with friends.

What is the most advantageous way to prepare this tax return?

This taxpayer had filed as "Single" in the prior year. The question "Have you ever been married?" identified this error. Filing as Married Filing Separately is a possibility but filing as Head of Household would be more attractive because of the larger standard deduction and the possibility for EITC. Does he qualify as Head of Household?

This taxpayer is considered unmarried since his wife is a non resident alien. He keeps up a home which is, on occasion, the residence of his daughter. But is his home his daughter's residence for more than half of the year? If the daughter is with her friends at school during the week but home every weekend, this taxpayer has a reasonable claim. But his claim is weaker if she only comes home when she runs out of money.

But this taxpayer has a better option than Head of Household. He and his non resident spouse can elect to file a joint return. This return must include the income of the non resident spouse but this is not a serious disadvantage with low income taxpayers because the non resident spouse typically has very little income.

If the taxpayer files a jointly return, he might be eligible for the EITC. Eligibility hinges on the same "how much time does daughter spend with dad" issue as affects Head of Household filing status.

Two issues remain. We need to get the spouse's signature on the tax return and we need to get her a tax identification number (ITIN). The instructions to Form W-7 demand that original identification documents such as a marriage certificate and passport be included with the application. I considered this unrealistic in these circumstances and advised the taxpayer to provide copies instead.

I told him to not file the return until the IRS had issued the ITIN. A late filing was OK because he was getting a refund. When I saw him following year, the taxpayer had just received his refund. I asked why the refund had taken so long. "They insisted on seeing original documents." was his reply.

We have been discussing, up to now, immigrants who established residency in a prior year and who were therefore residents throughout the entire current year. In the year that an immigrant first enters the U.S., they are likely to be a non resident for at least part of the year. If someone is a resident for part of the year, they are a "dual-status alien." The basic approach is to file a Form 1040 for the period of residency reporting

worldwide income and a Form 1040NR for the rest of the year reporting only U.S.-sourced income.

A married couple and their school-aged daughter immigrated to the U.S. in April and they were issued green cards upon arrival. The parents earned $14,000 in wages after their arrival and they had $3,000 in non-U.S. income prior to arrival. What is the most advantageous way in which to prepare their federal tax returns?

An immigrant with a green card is usually a U.S. resident from the date when the card is issued. This couple and their daughter are dual-status aliens in the year of entry because they are non residents for the first three months of the year and residents thereafter. Dual-status is unattractive for low income taxpayers because it means an extra return, because there is no standard deduction or EITC and because married dual-status aliens must file separately.

It is fortunate, therefore, that married dual-status aliens may elect to be treated as residents for the entire year[21]. This election is not available to unmarried persons.

If this couple elect to be taxed as full year residents, they are taxed on their worldwide income. Because their income is low, the extra tax is relatively small and it is more than offset by the EITC. As detailed in the appendix, electing to be taxed as residents rather than as dual-status aliens, means that this couple pays $2,263 less tax.

The same vignette but the issue is "How to prepare the California returns?"

As discussed previously, the filing status on the California return must generally be the same as the status on their federal return. That is, a married dual-status alien must file separately for California purposes[22] while a married dual-status couple who elect to be treated as U.S. residents must file a joint California return.

The California return will be a part-year return. The low income assistance program volunteers do not normally prepare part-year returns. However, the couple's worldwide income is only $17,000. Since this is below the California filing threshold and no California tax was withheld, there is no reason to file a California return.

Immigrants, even if they are filing as Married Filing Separately, are eligible for a partial renter's credit. This is a non refundable credit and thus not relevant in this vignette.

The same vignette except that the family arrived in August without benefit of green cards. How does this affect their tax returns?

An immigrant does not need a green card to become a U.S. resident. They can become a resident by staying in the United States long enough. "Long enough" is determined by the substantial presence test. This test can be a bit dicey since the result depends on tax treaties, rules which count some days and exclude others and travel in an out of the U.S. But these low income immigrants have none of these complications.

If the family had entered the U.S. without green cards in April, they would have been considered residents under the substantial presence test from April. They would have

[21] The election is mentioned in Publication 17, Chapter 2, and described in Publication 519, Chapter 1.

[22] FTB Legal Ruling 95-1. This ruling is available at http://www.ftb.ca.gov/legal/index.html.

been dual-status aliens exactly as in the prior vignette and they would have been entitled to elect to be taxed as residents for the entire year.

Since they actually entered the U.S. after July 1st, it is mathematically impossible for them to achieve residency under the substantial presence test until January 1st of the following year. They will be considered non residents the entire year of entry. The basic approach to their federal tax liabilities is to file two separate Forms 1040NR (with the disadvantages discussed above) for the year of entry. But another election, "the first year choice," allows them to backdate residency to the year of entry[23].

The first year choice means that they are dual-status aliens in the year of entry and eligible to make a second election to file as residents. The combination of these two elections allows the returns to be prepared as previously discussed.

An immigrant cannot elect the first year choice until the substantial presence test has been satisfied. Therefore, someone preparing a return based on the first year choice needs to prepare an extension of time to file (not time to pay!) and to advise the taxpayer to delay filing the immigration year return until July 1st of the following year.

A parent may make the first year election on behalf of their child. Without the first year choice election, the child would not be a resident and would not be considered a dependent.

There are additional considerations when preparing a return for an immigrant who is not low income. The tax on non-U.S. sourced income can be significant, there may be significant itemized deductions from outside the U.S. and the substantial presence test may be influenced by travel in and out or by treaty provisions.

The rules for splitting community wage income never apply for federal purposes if the spouse is a non resident and they don't apply for California purposes if the taxpayer is a temporary worker who intends return home.

The not low income immigrant can probably exclude most of their foreign wages for the years of entry and departure even if they must file or elect to file a resident U.S. tax return. (They might instead claim a credit for foreign taxes paid on this income.)

A Canadian citizen enters the U.S. in May with a temporary work visa. He earned $20,000 before coming to the U.S. and $60,000 working in California. He wife remained in Canada where she earns $20,000 annually. He paid $4,000 in California income tax withholding and the couple had $10,000 in mortgage interest and property taxes on their home in Canada.

What are the federal and California filing options?

This individual is a U.S. resident under the substantial presence test and eligible, if he and his wife so elect, to be treated as U.S. residents for the entire year. But he is also a Canadian resident and the U.S.-Canada income tax treaty says that he is entitled to be treated as a U.S. non resident even though the substantial presence test may say otherwise. Treaties provide options rather than requirements and taxpayers can chose to forgo treaty provisions.

This individual has three federal filing options. He could

[23] Publication 519, Chapter 1.

1. Claim the treaty provision and file a Form 1040NR. This means that only his U.S. wages are taxed but he must file Separately. A non resident is not entitled to the standard deduction and his itemized deductions are limited to the California income tax withheld. The federal tax liability is about $11,500.

   U.S. wages are reported in full on a Married Filing Separately federal return since community income rules are disregarded when one spouse in a non resident alien.

2. File Form 1040 Separately as a dual-status alien. Itemized deductions increase by half of the mortgage interest and real estate tax. The federal tax is about $9,500.

3. Elect to file a Joint Form 1040 with his spouse reporting their world wide income. This option provides an extra personal exemption and lower tax rates and allows all of the mortgage interest and real estate tax as itemized deductions. The couple must report worldwide income but it happens that they can exclude all of their Canadian earned income on Form 2555. The federal tax liability is about $5,400.

California does not permit the exclusion of foreign earned income. The California tax liability depends on how the federal return is completed.

1. If the individual files Separately on his federal return, he must file Separately as a part year resident on Form 540NR. He reports his worldwide income of $80,000 and is entitled to an itemized deduction for some or all of the mortgage interest and real estate tax. The California tax, which is based on the ratio of his income while a resident to his worldwide income, is about $3.800.

2. If a Joint Form 1040 is filed, he and his wife file Jointly as part year residents on Form 540NR. They report worldwide income of $100,000 and are entitled pay tax at joint rates and to an itemized deduction for all of the mortgage interest and real estate tax. The California tax, which is based on the ratio of their worldwide income while he is a resident to their total worldwide income, is about $3,700.

3. Even if a Joint Form 1040 is filed, this individual is entitled to file Separately as a part year resident on Form 540NR since his wife is a non California resident for the entire year and because she has no California sourced income. (The California wages are not community income under California law since he is not California domiciled.) The return, and tax liability, are the same as for California option 1.

Electing to be treated as U.S. residents and filing a joint return in California provides the lowest tax liability. Additional details are in the appendix.

**Attracting Tax Professionals to the Low Income Assistance Programs**. Volunteering is personally rewarding because the programs benefit low income taxpayers and those who need encouragement to complete their own returns. Volunteering is intellectually stimulating because the returns are complex and because of the opportunity, especially with immigrants, to turn this complexity to the taxpayer's advantage.

But volunteering with the low income assistance programs has its frustrations, most of which have to do with the fact that there are too few volunteers.

- There are too few volunteers with the result that low income individuals are turned away. For example, the Tax-Aide program has had to reduce the days of operation at the Oakland Main Library from four to three days per week.

- Too few volunteers means no quality assurance. I'm not talking about math errors these since the computer corrects these automatically. My concern is the errors that the computer cannot detect (such as filing status or the taxable pensions or partnership distributions or the treatment of immigrants).

  I amend returns for at least one taxpayer each season as a result of an error by a prior preparer. Refunds are typically $500 to $1000 which is serious money to a low income taxpayer. This leads me to suspect that we make a dozen or more serious and undetected errors each year at the Oakland Main Library.

  A way to detect these errors is for experienced volunteers to sit in on the interviews or otherwise supervise those with less experience. This takes a lot of volunteers.

- The long term solution to too few volunteers is to change the law so that low income returns are less complex. This would have a couple of advantages. First, we lose new volunteers each year because they are scared away by the complexity. In addition it would be easier for low income taxpayers to learn to self-prepare if their returns were less complex.

  We will see a bit less complexity in 2002 with the changes to the EITC. Let's make this a trend by reducing the number of definitions for "child" and "foster child" and by revising age criteria so that they can be properly understood by the general population[24].

- Establishing priorities would allow too few volunteers to assist more of the targeted clientele. Evans Young already enforces a "seniors first" policy at the Oakland Main Library. The next step is to establish an income priority.

  This is a difficult issue. Should priorities be comparable to median incomes or to the lower Section 8 limits or to a multiple of the poverty level[25]? Should regional differences be addressed? What about family size and non taxable income like Social Security? Should priorities be based on income or on AGI? What about those with low incomes who own homes or have substantial investment portfolios?

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[24] Calendar anomalies cause "age" to be measured from the day before one's calendar birthdate. Because the Internal Revenue Code sets out age-related criteria in a simple fashion, the taxpayer is forced to deal with the complexity.

For example, Publication 17 defines Rule 10 (EITC without a qualifying child) as "You must be at least age 25 but under age 65." I doubt that many taxpayers realize that this means that the credit is limited to individuals whose 25th birthday is no later than January 1st and whose 65th birthday is no sooner than January 2nd, both measured in the year immediately following the taxable year.

My suggestion is to revise IRC §32(c)(1)(A)(ii)(II) to read "...has attained age 25 plus one day but has not attained age 65 plus one day before the close of the taxable year ..." With this change, Rule 10 in Publication 17 would come to mean what the casual reader presently thinks that it does mean.

[25] The 2002 median income for a family of four is $54,000 nationally, $61,000 for California and $75,000 for the Oakland, California "income limit area" which represents the Alameda and Contra Costa counties. The Section 8 income limit is $22,000 for a family of four in the Oakland area. The 2001 national federal poverty thresholds are $14,000 and $18,000 for families of three and four respectively. (References: www.huduser.org/datasets/il/fmr02/medians.pdf for the methodology and for the national and California data; www.huduser.org/datasets/il/fmr02/prts801_02.pdf for the Oakland data; www.census.gov for the poverty thresholds. Numbers have been rounded to reflect forecasting uncertainties.)

Because of these practical and philosophical complexities, we should probably think in terms of local guidelines rather than national limits and we need guidelines which is simple enough to be easily understood.

My suggestion is to give priority to seniors and to link the income guideline for others to the EITC limit. This is currently about $33,000[26].

Whatever the limit adopted, it should be posted at the site so that individuals don't wait for hours only to be told that they don't meet the guidelines.

- The focus of the national training syllabus is on "basic returns[27]" of no more than moderate income. I suspect, but do not know, that our too few volunteers would go further if the training were focused on low income returns of no more than moderate complexity[28].

  For example, training on splitting community income[29] would mean that the Tax-Aide program would no longer routinely turn away low income taxpayers with marital difficulties from the Oakland Main Library. I'd make time in the schedule by de-emphasizing existing topics which appear infrequently on low income returns.

  Even if there were no changes to training, the programs could handle more of the low income returns which arise if there were some mechanism, a questionnaire perhaps, to identify the returns which are beyond the scope of the training so that they could be routed to the appropriate volunteers.

The low income assistance programs could assist more low income taxpayers if they were to recruit more professionals into the programs or if they were to establish partnerships with those professionals who are willing to accept *pro bono* referrals.

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[26] The IRS used an EITC-linked guideline at its Oakland site last Spring and they were referring taxpayers to the Tax-Aide program when incomes exceeded their guidelines. The tax clinic sponsored by the IRS sponsors at Cal State Hayward bases their income guideline on 250% of the poverty level considering family size (www.sbe.csuhayward.edu/acct/taxclin.html). This is $45,000 for a family of four.

An income guideline linked to the EITC limit would qualify about a fifth of the families in Alameda and Contra Costa counties for assistance. (For 2002, the 10th, 20th, 30th and 70th income percentiles are $22,000, $37,000, $50,000 and $104,000 respectively for a family of four in the Oakland income limit area. Reference: www.huduser.org/datasets/il/fmr02/prt02med.pdf.).

Using an AGI guideline rather than an income guideline would favor seniors because less than half of Social Security benefit is generally taxable at these income levels, but it would be complex to implement. Most of the seniors assisted at the Oakland Library are low income and few seniors would be affected if the application of the income guidelines was left to the discretion of individual volunteers.

[27] "Through the assistance of trained volunteers from the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs, the Internal Revenue Service is able to offer free tax help to people who cannot afford professional assistance. Volunteers help prepare basic tax returns for taxpayers with special needs, including persons with disabilities, those with a low income, non-English speaking persons and elderly taxpayers." From a letter beginning "WELCOME, VOLUNTEERS!" by Mark E. Pursley, Director, Stakeholder Partnerships, Education and Communication, IRS, October 15, 2001.

[28] Volunteers are not liable for harm caused if they're acting within the scope of their responsibilities and if the harm was not willful. But personal risk is possible if a volunteer prepares a return which is outside of the national guidelines. This is not of concern to a professional with liability insurance.

[29] The training materials include an example which was designed to illustrate the deductible IRA limits for a married couple filing separately. The IRS-approved answer is wrong in a community property state.

Since my audience are tax professionals this evening, let me address what I think needs to happen to encourage more professionals to participate in the low income assistance programs. Since low income returns often involve refunds, the more complex returns could be addressed by a professional after the Spring filing season. My suggestion is to operate the low income programs year round and to rely primarily on professionals during the off season.

Income guidelines might change the perception that the low income assistance programs are competing with paid preparers.

I'd revise the program materials to say that quality tax assistance is not a commodity. The reason that professional assistance is better than the assistance of a volunteer is not that the professional has better training or more experience. The benefit from professional assistance is that the relationship is a continuing one. A continuing relationship means quality assurance, audit support and malpractice protection.

We should explore ways for low income taxpayers to obtain assistance outside of the context of existing programs. For example, we should consider paying preparers from the tax refund, and perhaps even subsidizing low income returns, via an electronic payment to the preparer of e-filed returns. I suspect that EITC compliance would improve if the IRS knew how to get to preparer's bank accounts[30]!

It is becoming increasingly burdensome to prepare returns by hand. Any Tax-Aide volunteer in the Bay Area who wishes to prepare returns on a computer can probably do so. But computer preparation presents its own difficulties, difficulties which must be resolved if more professionals are to be attracted to the program.

- Computer preparation in the context of a low income program is less efficient than in private practice because there is no practical way at present to roll over a *pro forma* return from the prior year. Don Irvine estimates that the sites could, potentially, assist 40% more taxpayers if returns could be rolled forward.
- A volunteer is going to think twice about using a computer if he has to lug the equipment home at night from a site which does not provide secure storage and a telephone line for e-filing. Not withstanding this difficulty, volunteers like Evans Young lug a laptop and printer to and from the Oakland Main Library.
- It takes time to learn tax software. Maybe it is only a few hours but this learning curve is one more thing to dissuade a busy professional. And, since the software is chosen by low bid, a volunteer might have to learn different software every year!
- Some professionals already have tax software loaded onto a laptop computer. They might be willing to prepare returns at a low income site using their laptop and to e-file the returns from their office using a TCE e-FIN. This is a only partial solution since it does not make a printer available at the site and there will be a difficulty if the professional has not purchased an unlimited software license.

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[30] Unlicensed and unsupervised preparers have the poorest EITC compliance record. See Michael A. O'Connor, CCH's *Journal of Tax Practice and Procedure*, as reproduced in the *EA Journal*, **19**(3) and **19**(4), 2001.

The subsidy cost would be offset by reduced demand for low income tax assistance, which O'Connor estimates costs the IRS as much as $60 per return or by slowing the annual increase in the EITC limits.

The license issue might be resolved if the program sponsors asked the vendors to allow their existing customers to use the vendor's software in the low income assistance programs. Permitting such use would not cost the vendors a penny and they could create a tagline in the paid preparer area which reads "TCE 9461208. Software provided as a public service by ABC Company."

Encouraging professional participation is a bit of a chicken and egg situation. Professionals are reluctant to participate without program changes and program sponsors are reluctant to consider changes without the assurance of professional participation. Someone has to make the first move.

I have appealed to your charitable instincts and to your intellectual curiosity. Let me close by appealing to a more base motivation: free CPE. Northern California EA and CPA volunteers can earn 18 hours of CPE by completing the free training, passing the open book examination and fulfilling the minimum commitment of forty hours during the tax season. EAs and CPAs in active status, who do not desire CPE credit, can volunteer in these programs without the training and examination.

**Acknowledgement**. It is a joy to teach under the supervision of Baird Whaley, Lead Instructor in Alameda County. Baird's frustration with the definition of "foster child" stimulated me to include this issue in this presentation.

I also wish to thank Baird Whaley, Patrick M. Brown (TCE/VITA Coordinator), Don W. Irvine (Northern California Tax-Aide Coordinator), Shug Madokoro and Evans Young for factual and editorial suggestions. Shug, and subsequently Evans, have managed the Tax-Aide site at the Oakland Main Library for many years.

There would be no low income tax assistance programs without those unsung heroes who volunteer four and five days a week during tax season.

# Appendix. Tax Preparation for Low Income Immigrants

Or, How elections can make quick work of NRA returns.

**Introduction**. The taxation of immigrants is distinguished by the concepts of residency and U.S.-sourced income. If the taxpayer is a resident for the entire year, they are taxed on their worldwide income using the same rules as U.S. citizens.

For periods when the taxpayer is not a resident, they are only taxed on U.S.-sourced income. This generally means wages earned in the U.S., income from a U.S. business or from a business which operates in the U.S., from U.S. real estate or from a U.S. partnership or trust, interest and dividends from U.S. securities and gains and losses from the sale of U.S. securities, real estate and business assets. A non resident is generally not taxed on interest from a U.S. bank.

A non resident pays tax on U.S.-sourced income under a set of rules that are similar to the rules which apply to residents. Similar is a polite way of saying that the rules are different. The situation is exacerbated by bilateral treaty agreements, meaning that the U.S. tax paid by a citizen from one country might be different from the U.S. tax paid by the citizen of another country.

Non residents generally have to file something with the IRS even if they have no U.S.-sourced income. For example, students are generally non residents and must file a Form 8843 annually confirming their eligibility to be treated as non residents. They must file Form 1040NR if the have any U.S.-sourced income, even $10 worth.

If the taxpayer is a resident for part of the year, such as in the year of immigration, they are a "dual-status alien." This generally means filing two returns, a Form 1040 for the period of residency and a Form 1040NR or other statement for the balance of the year, although. However, as we shall see, elections may simplify tax reporting.

The focus of this appendix is on identifying situations in which a non resident will benefit from elections which allow the return to be completed under the normal rules.

There are a substantial number of immigrants among those seeking help from the volunteers at the Oakland, California Public Libraries. Most are U.S. residents or citizens and do not present special challenges.

But about one in ten have spouses or children living abroad or are dual-status aliens or students or taxpayers with temporary work visas. These individuals must be identified during the interview process since their returns are not prepared by the usual rules.

Having identified a special situation, the preparer has to decide whether to prepare the return or whether to refer to a more experienced preparer or outside the program. As always, the preparer should be guided in this decision by what is best for the taxpayer and should not attempt a return unless they are confident that the return will be accurate and will reflect the lowest possible tax liability (or largest refund).

Taxpayers with substantial U.S.-sourced income before they enter the U.S., or substantial foreign income after they arrive in the U.S., should be assisted by someone who specializes in international taxation. Taxpayers who travel in and out of the U.S.,

and teachers, trainees and students should also be referred to a specialist since these factors complicate the residency determination[31].

With this introduction under our belts, let us turn to the determination of residency for immigrants, visitors and their dependents, two elections which allows non residents and dual-status aliens to be taxed as U.S. residents, an election which allows someone to be treated as a resident in the year before they actually qualify and California's taxation of immigrants and visitors.

**U.S. Residency**. There are two ways to establish U.S. residency. One can be granted lawful permanent residence. This is the so-called "green card test." One can have the right to work in the U.S. without having permanent residence.

One can also become a resident by staying in the United States long enough, legally or otherwise[32]. "Long enough" is determined by the substantial presence test.

This test can be a bit dicey since the conclusion depends on tax treaties and on rules which count some days and exclude others. For example, someone who regularly commutes to work in the U.S. from Canada or Mexico does not count these days; crew on a foreign vessel do not count days in U.S. waters; changing planes in the U.S. does not count but having a meeting at the airport before changing planes does, and someone who can't leave because of a medical condition might not count certain days.

The test also does not count days when one is an "exempt" individual. One is exempt if they are in the U.S. temporarily and are a

- Foreign-government related individual. The spouse and unmarried children under age 21 might also be exempt.
- Teacher, trainee or student with a "J, "Q", "F" or "M" visa, but only if they substantially comply with their visa requirements[33]. The spouse and unmarried children under age 21 might also be exempt.

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[31] VITA sites on some college campuses assist with some of these returns.

[32] The term "United States" is defined as the fifty states, the District of Columbia, U.S. territorial waters and the seabed over which the U.S. has exclusive mining rights under international law. The term does not include U.S. territories or possessions or U.S. airspace. This definition means that someone whose plane lands in St, Louis at 1 am is present in the U.S. from the day that they arrive while someone whose boat docks in New York at 1 am is present in the U.S. from the day before they arrive

One day more or less is generally meaningless but it could affect eligibility for the EITC or the dependency exemption in a particular circumstance.

[33] Reg 301.7701(b)-3. Substantial compliance. An individual described in paragraph (b)(3) or (4) of this section will be deemed to comply substantially with the visa requirements relevant to residence for tax purposes if the individual has not engaged in activities that are prohibited by the Immigration and Nationality Act and the regulations thereunder and could result in the loss of F, J or M visa status. An individual will not be deemed to comply substantially with the visa requirements relevant to residence for tax purposes merely by showing that the individual's visa has not been revoked. An independent determination of substantial compliance may be made by the Internal Revenue Service for any individual claiming to be an exempt individual under paragraph (b)(3) or (4) of this section. For example, if an individual with an F visa (student visa) is found to have accepted unauthorized employment or to have maintained a course of study that is not considered by the Internal Revenue Service to be full-time, the

A student is generally not a resident and they usually report their income on a Form 1040NR rather than a Form 1040.

- Professional athlete competing in a charitable event. However, travel days and practice days are not exempt.

Travel in and out complicates the test. It can affect the date from which residency is measured and it could mean that the traveler is a resident one year and a non resident the next. For example, someone who usually visits the U.S. for 120 days a year is a non resident. But, if they were to be in the U.S. for 130 days one year - Bingo! - they could be a dual-status alien[34]. They would remain a resident for at least part of the following year if they were in the U.S. for 120 days but they would revert to non resident status if they limited their time to 116 days or less[35].

Because of these potential complications, I'm limiting the discussion of residency to green card holders and to undocumented aliens who are in the U.S. without a visa or who have overstayed or otherwise violated their visa requirements[36]. I'm also going to assume that, once an immigrant enters the U.S., they stay put. These simplifications allow us to apply the substantial presence test without considering visas or travel.

The immigration and emigration years are special because the taxpayer is a "dual-status alien." That is, they are a non resident for part of the year and a resident for the rest of the year. If an immigrant is a resident under the substantial presence test, the residency starting date is the first day that they are present in the U.S. during that calendar year, assuming no travel in and out. Thus an immigrant who enters the U.S. before July 2nd will usually be a non resident before the immigration date and a resident thereafter.

In contrast, an immigrant who enters the U.S. after July 1st will usually become a resident as of January 1st of the following year. Such an immigrant will be a non resident in the immigration year[37] and a resident thereafter.

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individual will not be considered to comply substantially with the individual's visa requirements regardless of whether the individual's visa has been revoked.

"Unauthorized employment" depends on the facts and circumstances and the INS does grant permission to work because of economic hardship. (See the Comprehensive Example in Chapter 5 of Publication 678-FS.) But the comment of a consular officer (who hung up when I asked for her name) is instructive. She said that a student working twenty hours a week unrelated to their training "is breaking the rules."

[34] If an individual can establish a closer presence with a foreign country and if they are in the U.S. less than 183 days, they are treated, under §7701(b)(3)(B), as a non resident. File Form 8840.

[35] One ceases to be a resident under the substantial presence test on the day after leaving the U.S. for the last time in a calendar year if one has a closer connection to a foreign country after leaving the U.S. and if one is not a resident at any time during the next calendar year. §7701(b)(2)(B). A filing is required by the due date of the tax return to establish a residency termination date Reg. 301.7701(b)-8.

[36] For visa requirements, see http://travel.state.gov/visa_services.html#niv or (202) 663-1225.

[37] A non resident must file if they were engaged in a business in the U.S. even in there is no U.S.-sourced income or if the U.S.-sourced income is tax exempt. This category includes anyone with U.S. wages and also most teachers, trainees and students with a "J, "Q", "F" or "M" visa even if they don't have wages.

Other non residents must file only if insufficient tax was withheld on U.S. capital gains and on interest and dividends paid by U.S. investments. See the instructions to Form 1040NR for further discussion.

For an immigrant with a green card, the residency starting date is generally the later of the immigration date or the date when the green card is issued. An immigrant with a green card is a dual-status alien in the immigration year, unless they happen to enter the U.S. on January 1st. If the immigrant were to meet the substantial presence test in the same year the green card test is issued, residency begins on the immigration date if this is earlier than the green card date.

Residency also affects the dependency exemption. If the child of an immigrant, for example, is not a resident at some time during the year, no exemption can be claimed on the Form 1040. (Residency in this context includes residents of Canada or Mexico.)

*A couple are U.S. residents in the year of immigration. They support two daughters who are full time college students in Hong Kong.*

*Do the children qualify as dependents?*

Applying the usual five dependency tests, the daughters are dependents if they are U.S. residents for at least some part of the year[38]. If the children entered the U.S. with green cards or met the substantial presence test and subsequently left to attend school, they are dependents. If the children never came to the U.S., they are not residents[39] and they are do not qualify as dependents.

**The First Year Election**. As discussed above, an immigrant who enters the U.S. after July 1st without a green card doesn't become a resident until they satisfy the substantial presence test. Mathematically, this cannot occur until the following tax year, at the earliest. This generally means that the immigrant must file as a non resident in the immigration year.

However, a non resident can elect to be treated as a dual-status alien in the immigration year if they meet the substantial presence test in the following year and if immigration was prior to December 2nd[40]. This "first year choice" allows an immigrant to backdate residency to the year before the year in which the substantial presence test is met.

An immigrant making this election[41] is a dual-status alien in the immigration year and the period of residency is measured from the date of entry into the U.S., assuming no travel in and out or other complications.

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[38] IRS Publication 17, Chapter 3 and Reg. 1.152-2(a)(1).

[39] Rezazadeh v. Comm., 17 AFTR 2d 416 (356 F.2d 898), 03/01/1966. Children were granted lawful permanent residency status but they never came to the U.S. The Seventh Circuit Court of Appeals concluded that the children were not residents and upheld the denial of the dependency exemption.

[40] IRC §7701(b)(4).

[41] To make the election, a signed statement is filed with the immigration year return declaring

- The taxpayer is making the "first-year election" for the immigration year.
- The taxpayer was not a resident in the year before immigration.
- The taxpayer is a resident under the substantial presence test for the year after immigration.
- The number of days of presence in the U.S. in the year after immigration.

The first year choice election can't be made until the individual has been in the U.S. long enough to satisfy the substantial presence test. Since it is mathematically impossible to satisfy the substantial presence test prior to the April filing deadline, the return should be prepared on the basis of the first year choice, the tax liability should be paid by April 15th and the time to file extended, and the taxpayer should be advised to file the return on or after July 1st[42].

*The mother of a U.S. resident enters the U.S. in October on a visitor's visa but does not leave the U.S. at the end of the visa period. The U.S. resident is the mother's sole support and the mother has no other income.*

*Does the mother qualify as a dependent in the year of entry?*

The answer hinges on when the mother is considered a U.S. resident. Since the mother is not a lawful permanent resident, she is not a dependent until she becomes a resident under the substantial presence test. The mother entered the U.S. after July 1st, and she therefore becomes a resident, and a dependent, on January 1st of the year following entry. She is not a dependent in the year of entry.

The mother can elect the first year choice since she was in the U.S. 31 days or more since she will satisfy the substantial presence test in the year following immigration. With this election, the mother qualifies as a dependent in the year of entry.

Since dependency depends on the first year election, the filing of the return claiming the mother as a dependent must be delayed until the substantial presence test is met.

How does the mother make the first year election since her income is so low that she is not required to file a tax return? One suggestion[43] is to attach the election declaration to the return on which the mother is claimed as a dependent.

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- The date or dates of a 31-day period of continuous presence in the U.S. in the immigration year. (This requirement means that someone who enters the U.S. after December 1st is not eligible for this election.)
- The date or dates of absence from the U.S. during the immigration year that are treated as days of presence.

  The purpose of this question is that one must remain in the U.S. 75% of the time after the beginning of the 31-day continuous presence to be eligible for the first year election but one can treat up to five days of absence as days of presence. Suppose someone comes to the U.S. November 1, departs 31 days later on December 1st, returns on December 20th and remains for the rest of the year. This individual is in the U.S. 43 days or 70% of the days from the beginning of the 31 day continuous interval. This fails the 75% test. If five days of absence are reclassified as days of presence, the individual is in the U.S. for 48 days or 78% of the time, thereby satisfying the 75% test. Most immigrants, especially low income immigrants, meet the 75% test without having to reclassify days.
- Taxpayer's name, address and Social Security or tax identification number.

If the election is being made on behalf of dependent children, then the statement must also include the required information with respect to those children. The election need not be for the immigration year.

[42] The substantial presence test will be satisfied sometime in the period between May 1st and late June, the exact date depending on the date of entry to the U.S. There is nothing to be gained by filing before July 1st if the tax liability was paid in April. I suggest filing on July 1st because this means that the preparer need not understand the operation of the substantial presence test.

[43] IRS International Hotline, employee 2804261, March 7, 2002.

A parent may elect the first year choice for a dependent child if the individual is qualified to make an election on their own behalf, if the child qualifies for the election and if the child is not required to file an income tax return for the year for which the election is to be effective. A dependent child for this purpose is a son or daughter of the individual (or a descendant of either), or a stepson or stepdaughter, and the usual requirement that a dependent be a resident or citizen does not apply[44].

**6013(h) Election for Dual-Status Aliens**. If someone becomes a U.S. resident during the year (that is, if they are a dual-status alien), and if they are married to a U.S. resident or citizen, they may elect to be treated as a U.S. resident for the entire year so long as both spouses agree to file a joint return reporting worldwide income[45]. The election applies if both spouses are dual-status aliens so long as both are residents at year's end. The election is not available to unmarried persons.

This election simplifies tax preparation because fewer returns are required and because all of the usual rules apply to the Form 1040. In addition, the couple may benefit from larger deductions and lower tax rates and they may be able to claim EITC or to pay less tax on Social Security benefits. The potential downside to this election is that there may be a tax liability on non-U.S. income. I say potential downside because it is often possible to exclude non-U.S. earned income in the entry year or this extra tax may be small in comparison to the tax benefits of the election.

Although there is no requirement to specifically identify worldwide income, I recommend doing so. When all of the non-US income is taxed at ordinary rates, it could be entered on line 21, for example.

**6013(g) Election for Non Resident Aliens**. If someone is a non resident at the end of the year and if their spouse is a U.S. resident or citizen at the end of the year, they may elect to be treated as a resident if both spouses agree to file a joint return reporting worldwide income [46].

This election can be attractive when the non resident spouse has little income, or if this income can be excluded, since it increases the standard deduction available to the

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[44] Reg §301.7701(b)-4(c)(3)(v)(B).

[45] Reg. §1.6013-6 describes the statement to be attached to the return.

ELECTION UNDER IRC §6013(h) TO BE TREATED AS U.S. RESIDENT FOR ENTIRE YEAR

We declare that we are married and that one or both of us are U.S. citizens or residents as of the end of calendar year XXXX. We elect to be treated as U.S. residents for the entire XXXX calendar year.

Signed _____ Signed _____

NAME OF FIRST SPOUSE
Social Security Number or ITIN
Address

NAME OF SECOND SPOUSE
Social Security Number or ITIN
Address

[46] The election is made by attaching a statement to the return, signed by both spouses, to the effect that one spouse is a non resident alien and that the other a U.S. citizen or resident and that both spouses elect to be taxed as residents. Include the names, addresses and tax identification numbers of both spouses. The election is good until terminated by the taxpayers or the IRS, by the death of either spouse or by divorce, and the election does not apply for a year in which neither spouse is a citizen or resident. This election is mentioned in Publication 17, Chapter 2 and is described in Publication 519, Chapter 1.

resident spouse who would otherwise have to file Married Filing Separately or as Head of Household. It also doubles the number of personal exemptions and lowers the rate of tax. This election might make the resident spouse eligible for the EITC and it might reduce the portion of Social Security benefits which are subject to tax.

A downside to this election is that there can be practical difficulties obtaining a tax identification number on behalf of a spouse who is outside the U.S.[47].

*The husband is a U.S. resident with $12,000 in worldwide income. His spouse lives in Ethiopia. She has little income.*

This taxpayer can file as Married Filing Separately or he can elect to file a joint return with his non resident alien spouse. Filing jointly produces the lower tax liability.

Elections can be combined with powerful effect. Let's extend a prior vignette.

*A U.S. citizen or resident is the sole support of his parents who live outside the U.S., Canada or Mexico. The mother establishes U.S. residency through the first year choice, and is properly claimed as a dependent of her son's tax return.*

*How might the father be claimed as a dependent?*

The son can probably claim both parents as his dependents if the resident mother and the non resident father elect under §6013(g) to be treated as U.S. residents, if the son provides more than half of their support and if their worldwide income is low enough so that the Gross Income test is satisfied and the couple do not have a filing requirement[48]. Since the parents don't file a tax return, the election declaration would be attached to the return on which the son claims his parents as his dependents.

The usual residency result as a function of the immigration date is as follows.

**Residency Status in Immigration Year**

(Excludes multiple entries and exemptions due to visa, treaty or medical reasons.)

| | Immigration Before July 2nd | After July 1st |
|---|---|---|
| Green card | Dual-status | Dual-status alien |
| No green card | Dual-status | Non resident; dual-status alien if first year choice |
| Married and electing to be treated as residents under §§6013(g) or 6013(h) | Resident | Resident if either spouse has a green card or elects the first year choice |

[47] The non resident alien spouse needs a tax identification number (ITIN) to make this election. It is best to apply for the ITIN in person rather than to apply by mail. If the applicant is outside the country, the application and required documents should be forwarded to the U.S. spouse who will deliver the materials to an IRS office in the U.S. It is prudent to extend the time for filing any tax return requiring a new ITIN.

[48] I have not seen this scenario elsewhere and I am worried about the joint return test. The IRS considers the filing of a joint return, when income is below the filing threshold, as a claim for refund rather than a tax return, see Rev. Rul. 65-34. Thus the joint return test is inoperative. However, this joint return might be considered differently since it is being filed pursuant to a §6013(g) election and not to claim a refund.

**Taxation of Dual-Status Aliens**. The basic procedure is to file a Form 1040 return reporting worldwide income from the day residency is established through the end of the calendar year and to file a Form 1040NR or equivalent statement reporting U.S.-sourced income, and the U.S. tax thereon, between January 1st and the day before residency is established. If there is no U.S.-sourced income prior to residency, the Form 1040NR or statement will show a zero U.S. tax liability.

Write "Dual-Status Return" across the front of the Form 1040 and file the return together with Form 1040NR or equivalent statement with the IRS Service Center in Philadelphia. Write "Dual-Status Statement" across the front of the Form 1040NR[49].

Filing as a dual-status alien is not attractive to low income taxpayers because of the statutory limitations on how the short year Form 1040 must be prepared.

- Dual-status aliens are denied the Earned Income, the Education and Elderly Credits and the standard deduction. Itemized deductions are allowed, if any.
- A married dual-status alien must file as Married Filing Separately for both federal and California purposes. An unmarried dual-status alien must file as Single or as a Qualifying Widow(er)[50]. A dual-status alien may not file as Head of Household.

The following vignette is patterned after the examples in FTB Legal Ruling 95-1.

*One spouse is a resident the entire year. The other spouse and a dependent child enter the U.S. during the year.*

*What are the federal filing options? Is the child a dependent?*

The couple may elect to file Jointly under §6013(g).

Absent this election, the resident spouse may file Separately or as Head of Household if the child lived with the resident spouse in the U.S. for at least half of the year. (The resident spouse is considered unmarried for Head of Household purposes, even if they live with their spouse, because their spouse is a non resident alien.) The immigrating spouse files Married Filing Separately, dual-status returns or a Married Filing Separately non resident return depending on their residency status at year's end.

If the child is not a resident at year's end, he or she cannot be claimed as a dependent. If the child is a resident at year's end,

- The child can be claimed as a dependent by the resident spouse if the resident spouse filing Separately provided more than half of the support.

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[49] One can also be a dual-status alien in the year that residency is abandoned. In this case, the tax return is the Form 1040NR and the Form 1040 is the statement. Write "Dual-Status Return" across the front of Form 1040NR and "Dual-Status Statement" across the front of the Form 1040 or equivalent statement.

[50] Low income filers are seldom concerned with student loan deductions or child care credits or the taxation of Social Security benefits or of IRA contributions. Thus the primary effect of the filing status limitations is on the size of the standard deduction. Since dual-status aliens can't claim the federal standard deduction, it might appear that low income taxpayers are not affected by filing status limitations.

However, dual-status aliens are eligible for the California standard deduction. Since the filing status determines the California standard deduction, filing status matters for low income dual-status aliens.

- The child can be claimed as a dependent by the immigrating spouse filing Separately on Form 1040 if the immigrating spouse provided more than half of the support. Generally speaking, dependents are not allowed on a Form 1040NR.
- The child may be claimed as a dependent if the parents elect to file a joint return and if either or both parents provided more than half of the support

*A couple and their high school aged daughter immigrated to the U.S. in March, 2001. All had green cards and Social Security cards. The parents earned $3,000 during 2001 before coming to the U.S. One spouse earned $8,000 and the other $6,000 after coming to the U.S.*

*What is the best filing strategy?*

Wages are not community property for federal purposes if either spouse is a dual-status alien. Wages are not community property for California purposes if the earner's permanent home (domicile) is other than in a community property locale.

If this couple elect under §6013(h) to be taxed as U.S. residents rather than as dual-status aliens, they file a Form 1040 reporting worldwide income for the entire year. This approach entitles them to a $1,727 refund, plus any federal tax withheld, as shown by the computations in the "Resident Election" column of the following table.

| | Resident Election | Dual-Status, Spouse 1 | Dual-Status, Spouse 2 |
|---|---|---|---|
| Filing Status | MFJ | MFS | MFS |
| U.S. Wages | 14,000 | 8,000 | 6,000 |
| Non-US Wages | 3,000 | | |
| AGI | 17,000 | 8,000 | 6,000 |
| Deductions | (7,600) | | |
| Exemptions | (8,700) | (5,800) | (2,900) |
| Taxable Income | 700 | 2,200 | 3,100 |
| Tax Liability | 107 | 332 | 469 |
| Rate Reduction Credit | (35) | (110) | (155) |
| Earned Income Credit | (1,799) | | |
| **Tax Due** | **$1,727 refund** | **$536 combined balance due** | |

The refund may be a few dollars larger if there is a credit for foreign tax paid on the non-U.S. income. Alternatively, they could exclude the non-U.S. income (as will be demonstrated in subsequent vignettes) but they are unwise to do so since, if they claim the exclusion, they forfeit their eligibility for the earned income tax credit.

Without the election to be treated as U.S. residents, each adult must file a short year Form 1040 and a Form 1040NR or other statement reporting no U.S.-sourced income prior to entering the U.S. As shown in the prior table, the two short year Forms 1040 produce a combined $536 balance due, less any federal tax withheld.

Consequently, the election to be taxed as U.S. residents cuts this low income couple's federal income tax by more than two thousand dollars.

With or without the election, their daughter qualifies as the dependent of one or the other parent on the Form 1040 since she is a U.S. resident for some part of the year. Note that, generally speaking, one may not claim dependents on the Form 1040NR.

*A married couple entered the U.S. on October 1, 2001. They have green cards and are therefore U.S. residents and eligible to be treated as either dual-status aliens or as U.S. residents for the entire year.*

*Wages were $60,000 before entering the U.S. These are not U.S.-sourced. Wages were $20,000 after coming to the U.S. These are U.S.-sourced. Half of the income was earned by each spouse.*

*What is the best filing strategy.*

If the couple file as dual-status aliens, their combined U.S. tax liability is a bit over two thousand dollars. Their tax liability is less if they elect to be taxed as U.S. residents under §6013(h) and if they claim the exclusion[51] for foreign earned income.

| | **Dual-Status, Spouse 1** | **Dual-Status, Spouse 2** | **Residents & Exclusion** |
|---|---|---|---|
| Filing Status | MFS | MFS | MFJ |
| U.S. Wages | 10,000 | 10,000 | 20,000 |
| Non-US Wages | | | 60,000 |
| Form 2555 Exclusion | | | (60,000) |
| AGI | 10,000 | 10,000 | 20,000 |
| Deductions | | | (7,600) |
| Exemptions | (2,900) | (2,900) | (5,800) |
| Taxable Income | 7,100 | 7,100 | 6,600 |
| Tax Liability | 1,069 | 1,069 | 994 |
| Rate Reduction Credit | (53) | (53) | (330) |
| **Tax Due** | **$2,032 combined** | | **$664** |

California has no comparable foreign earned income exclusion although the non-U.S. income is discounted on the Form 540NR because it was earned prior to becoming California residents. The couple's combined California tax liability is about $460 more if they elect to file jointly on their federal returns. On balance, their total federal and California tax liability is somewhat less if they elect to be treated as U.S. residents.

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[51] Each spouse may exclude up to $78,000 times the ratio 297/365, where 297 is the number of days in the qualifying period. The "qualifying period" is any continuous twelve month period beginning or ending in the tax year during which the taxpayer is outside the U.S. for a cumulative total of 330 full days.

The twelve month ending October 24, 2001, the 297th day of the tax year, were chosen as the qualifying period since this provides the largest overlap with the 2001 tax year and hence the largest exclusion limit. Taxpayers were outside the U.S. for 330 full days from October 25, 2000 through September 30, 2001.

Foreign wages are included on line 7 of the Form 1040. The exclusion amount is calculated on Form 2555 and transferred as a negative entry to line 21 of the Form 1040. The return is filed with the Philadelphia Service Center.

See Publication 54 or the Form 2555 Instructions for additional requirements. The maximum exclusion increases to $80,000 in 2002.

The following vignette again illustrates the limited federal exclusion for foreign income. It also illustrates that there is no California exclusion, treaty benefits and the option to file Separate California returns if the non resident spouse has no California income.

*A Canadian citizen entered the U.S. May 1, 2001 with an H-1 visa. This visa allows him to work in the U.S. temporarily. He earned $20,000 before coming to the U.S. and $60,000 working in California. He wife remained in Canada where she earns $20,000 annually. He paid $4,000 in California income tax and the couple had $10,000 in mortgage interest and property taxes on their home in Canada. All amounts are in U.S. dollars.*

*What are the filing options for this couple?*

This individual is a U.S. resident as of the end of the tax year under the substantial presence test and eligible, if he and his wife so elect, to be treated as U.S. residents for the entire year under 6013(g). This election means they can exclude their Canadian income from the U.S. return[52], claim mortgage interest and property tax[53] for their home in Canada and benefit from joint tax rates and two personal exemptions. Their federal income tax liability is about $5,400 filing Jointly.

In a departure from the usual rule that a taxpayer must use their federal filing status on their California return, this couple may file their California returns Jointly or Separately because the wife was a California non resident for the entire year with no California sourced income[54].

- The California return includes the wife's income if the couple file Jointly because there is no California foreign earned income exclusion. The California tax, based on $100,000 in worldwide income, $74,000 in income by both spouses while the husband is a resident and $10,000 in itemized deductions, is about $3,700.
- If filing Separately, the husband's California return does not include his wife's income or her share of the itemized deductions. The California tax, based on $80,000 in worldwide income, $60,000 in income while a resident and claiming half[55] of the interest and mortgage deductions, is about $3,800.

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[52] Each spouse may exclude up to $78,000 times a ratio where the numerator is the number of days in the qualifying period and the denominator is the number of days in a year. The "qualifying period" is any continuous twelve month period beginning or ending in the current tax year during which the taxpayer is outside the U.S. for a cumulative total of 330 days. The exclusion amount is calculated on Form 2555.

The non resident spouse was outside the U.S. for the entire year and she may exclude her wages up to the $78,000 exclusion amount. The resident spouse may exclude his Canadian wages but the maximum exclusion is reduced by the ratio 154 / 365. (The qualifying period was chosen to be June 4, 2000 through June 3, 2001, the 154$^{th}$ day of the current tax year, since this provides both 330 days outside the U.S. and the largest overlap with the current tax year.)

California has no comparable provision and the Canadian income is included on the California return, or not, according to the usual rules governing part-year California residents.

[53] Publication 54, Chapter 5.

[54] Rev & Tax §18521(c)(2). See also the instructions to Form 540NR.

[55] An aggressive taxpayer would likely claim the full $10,000. An aggressive auditor would argue that these expenses were paid by the wife and that the husband should be limited to the standard deduction.

The husband is a resident of both the U.S. and Canada. Article IV of the U.S.-Canadian income tax treaty[56] says that a dual resident is treated as a Canadian resident rather than as a U.S. resident because Canada is his permanent home. (There is a similar provision in the U.S.-Mexico treaty.) This suggests that the husband should file Forms 1040NR and 540NR (Married Filing Separately, one personal exemption, deductions on the federal return limited to California tax). The U.S. tax liability would be about $11,500.

As discussed previously, the California tax filing separately is about $3,800.

A taxpayer has the option to claim or to not claim treaty benefits[57]. In this vignette, the taxpayer's combined tax liabilities are lower if the treaty is ignored.

The next vignette is patterned after the examples in FTB Legal Ruling 95-1.

*A couple and their dependent child immigrate to the U.S. They are not in the U.S. long enough to become residents during the immigration year but they are residents during the second year.*

*What are their filing options?*

The couple would ordinarily file Separate non resident returns for the entire year. However, if either spouse enters the U.S. before December 2nd, this spouse can elect the first year choice and will be treated as a dual-status alien in the year before the substantial presence test is met. Since, because of the first year choice, at least one spouse is a U.S. resident at the end of the immigration year, both spouses can elect under §6013 to file a Joint Form 1040 for the immigration year.

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[56] The text of the treaty is at www.irs.gov/pub/irs-trty/canada.pdf. Article IV begins as follows.

"1. For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature, but in the case of an estate or trust, only to the extent that income derived by such estate or trust is liable to tax in that State, either in its hands or in the hands of its beneficiaries.

"2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

"(a) He shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both States or in neither State, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (centre of vital interests);

"(b) If the Contracting State in which he has his centre of vital interests cannot be determined, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;

"(c) If he has an habitual abode in both States or in neither State, he shall be deemed to be a resident of the Contracting State of which he is a citizen; ...."

[57] Compare Treas. Reg. Section 301.7701(b)-7(e), Examples (3) and (4). "*Example (4).* The facts are the same as in Example 3, except that C does not choose to claim treaty benefits with respect to any items of income covered by the treaty (i.e., she files as a resident). Therefore, she is taxed as a resident under the Code and pays tax at graduated rates on her personal services income, dividends, and interest. In addition, she is entitled to deduct her mortgage interest expenses and to take personal exemptions for her spouse and three children. C will be entitled to file a joint return with her spouse if he is a resident alien for 1985 or, if he is a nonresident alien, C and her spouse may elect to file a joint return pursuant to section 6013."

**California Return**. Other than out-of-state military personnel stationed in California, almost everyone who is here for more than a few months is considered a California resident, especially if they are working rather than sightseeing. California residents are liable for California tax on worldwide income during the period of residency.

Immigrants are generally California residents from the day that they arrive in California. There is no waiting period or green card test and no exceptions for visas or treaties.

A new immigrant will generally be a part-year resident in the immigration year. They must file California Form 540NR if worldwide gross income is above the filing threshold. The California income tax is the tax on the worldwide income reduced by the ratio of income received while a California resident to worldwide income.

The filing status on the California return must generally be the same as the status on the federal return[58]. That is, married dual-status aliens who are required to file Married Filing Separately on their federal returns must also file separately for California purposes. A dual-status alien with a child must file as Single rather than as Head of Household on their federal and California returns. However, a resident whose spouse does not live in California may file Separately even if they elect to a Joint federal return so long as the spouse has no California sourced income. (This means that, in addition to not working or owning real estate in California, the wages of the resident spouse cannot be considered as community income.)

Low income taxpayers often qualify for the non refundable California Renter's Credit. Immigrants, even dual-status aliens who are married and filing separately, are eligible for a credit pro-rated for the months of residency if they were California residents for at least six full months and if they meet the income and other requirements[59].

**Splitting Community Income**. If someone is domiciled in a community property state, their wages are generally community income. (You are a resident of the place where you are living and domiciled in the place to which you intend to return.) Someone in the U.S. on a temporary visa may be a U.S. resident but they are probably domiciled outside the U.S. and their wages are probably not community income even if they are living in a community property state. An immigrant, by definition, plans on staying. Thus wages of an immigrant to California are generally community income.

The rules for allocating community income between spouses are modified for federal tax purposes when one or both spouses are non resident aliens for part of the year[60]. Basically, wages are the separate property of the wage earner. The government's

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[58] CA Rev & Tax §18521. The mort common exceptions are when FTB determines that the wrong status was used on the federal return, for example if FTB disallows Head of Household status, certain military personnel, and when one spouse is a non resident with no California sourced income. FTB Legal Ruling 95-1 addresses the California filing status of dual-status aliens.

[59] Instructions for California Form 540NR, tax year 2001. A resident who rents for one month gets a full credit but a part-year resident who rents for 11 months gets a partial credit. Go figure!

[60] IRC §879. See also IRS Publication 519, 2. Source of Income.

PLR 9104001 addresses the question of whether the community property rules apply at least during the period of residency in a dual-status year and concludes that they do not. While private letter rulings are not binding, this ruling is drafted with a very confident tone.

intent is to prohibit a resident alien from reducing his federal income tax by allocating half of his wages to a spouse who is outside the jurisdiction of the U.S. tax laws.

California has not conformed and the usual rules for splitting community income apply if a taxpayer is domiciled in California even if the spouse is a non resident alien.

**For additional information**. The IRS operates a hotline for assistance with international returns at (215) 516-2000 #1 #3. The hotline is not toll free and the quality is uneven but the wait is short and it can be helpful to discuss an issue even if the IRS representative cannot provide a definitive answer.

16,500 words