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Federal Tax Code Provisions of Interest to the Disabled and Handicapped

Louis Alan Talley

Research Analyst in Taxation

Economics Division

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Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 1 of 15

FEDERAL TAX CODE PROVISIONS OF INTEREST TO THE DISABLED AND HANDICAPPED

SUMMARY

In determining taxable income under present income tax laws, some relief is provided to those individuals with physical and/or mental disability or to those who help care for them. The special needs of these individuals are recognized through a number of special Internal Revenue Code provisions.

Among the provisions available to individuals are (1) an additional standard deduction amount for blind individuals ($600 for elderly or blind married individuals or $750 for elderly or blind single individuals - with an inflation adjustment for tax years beginning after 1988); (2) the itemized deduction for unreimbursed medical expenses to the extent that the total amount of such expenditures exceed 7.5 percent of adjusted gross income; (3) a one-time exclusion from the capital gains on the proceeds from the sale of a principal residence (up to $125,000 of the gain) by persons age 55 or over who must enter a nursing home for care; (4) the dependent care credit; (5) the special tax treatment of disability benefits; and (6) employee business expenses of handicapped workers, which is not subject to a floor.

Additionally, two provisions are especially designed to help businesses provide for the needs of the handicapped. Those two provisions are the targeted jobs tax credit which is available to employers who hire handicapped individuals undergoing vocational training and a $35,000 deduction per year for the removal of architectural and transportation barriers.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 2 of 15

CONTENTS

PERSONAL/DEPENDENCY EXEMPTION ............................................. 1

HEAD OF HOUSEHOLD FILING STATUS ........................................... 2

ADDITIONAL STANDARD DEDUCTION FOR BLINDNESS ............................... 3

MEDICAL DEDUCTION ......................................................... 3

RESIDENCE IN A SANITARIUM OR NURSING HOME ................................. 4

SPECIAL SCHOOLING FOR HANDICAPPED DEPENDENTS .............................. 4

CAPITAL EXPENDITURES ...................................................... 5

$125,000 EXCLUSION OF GAIN FROM SALE OF RESIDENCE ......................... 5

DEPENDENT CARE CREDIT ..................................................... 6

TAX TREATMENT OF DISABILITY BENEFITS ...................................... 7

SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS .......................... 7

WORKER’S COMPENSATION ..................................................... 8

FEDERAL EMPLOYEES’ COMPENSATION ........................................... 8

DISABILITY COMPENSATION OF CIVIL SERVANTS ................................. 8

DAMAGES RECEIVED FOR INJURY OR ILLNESS .................................... 8

ACCIDENT OR HEALTH INSURANCE BENEFITS ..................................... 8

REIMBURSEMENT FOR MEDICAL CARE EXPENSES ................................... 9

COMPENSATION FOR PERMANENT LOSS OR DISFIGUREMENT .......................... 9

VETERANS’ BENEFITS ........................................................ 9

DISABILITY RETIREMENT ..................................................... 9

Credit for the Elderly and the Permanently and Totally Disabled ........... 9

MILITARY DISABILITY BENEFITS .............................................. 10

TERRORIST ATTACK AFFECTING CIVILIAN EMPLOYEES ............................. 11

EMPLOYEE BUSINESS EXPENSES ................................................ 11

REMOVAL OF ARCHITECTURAL AND TRANSPORTATIONAL BARRIERS .................... 11

TARGETED JOBS TAX CREDIT .................................................. 12

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 3 of 15

FEDERAL TAX CODE PROVISIONS OF INTEREST TO THE DISABLED AND HANDICAPPED

Tax provisions with special application to the disabled and handicapped are briefly described in this paper. In determining taxable income under present income tax laws, some relief is provided to those individuals with physical and/or mental disability. Their special needs are recognized through a number of special Internal Revenue Code provisions available to individuals. Among the provisions available to individuals are (1) an additional standard deduction amount for blind individuals ($600 for elderly or blind married individuals or $750 for elderly or blind single individuals - with an inflation adjustment for tax years beginning after 1988); (2) the itemized deduction for unreimbursed medical expenses to the extent that the total amount of such expenditures exceed 7.5 percent of adjusted gross income; (3) a one-time exclusion from the capital gains on the proceeds from the sale of a principal residence (up to $125,000 of the gain) by persons age 55 or over who must enter a nursing home for care; (4) the dependent care credit; (5) the special tax treatment of disability benefits; and (6) employee business expenses of handicapped workers, which is not subject to a floor. In addition, businesses have available such provisions as a $35,000 deduction per year for removal of architectural and transportation barriers, and the targeted jobs tax credit.

PERSONAL/DEPENDENCY EXEMPTION

Frequently, the dependency exemption arises in the case of a taxpayer supporting a handicapped or mentally impaired individual. The dependency exemption has a value of $1,950 for 1988, $2,000 for 1989, and $2,050 in 1990. (The personal/dependency exemption is indexed to inflation and thus is likely to rise in future years.)

In order to claim a dependency exemption for any person under present law, five tests must be met:

1. Gross income test - a taxpayer cannot claim a person (other than the taxpayer’s child under the age of 19 or who qualifies as a student under the age of 24) as a dependent if the person had gross income of $2,000 or more for the tax year 1989 (or $2,050 in tax year 1990). In applying the gross income test, tax exemption income, such as compensation for injuries and sickness (including but not limited to worker compensation) and damages by court award or agreement, is not included in determining whether the taxpayer has furnished over half of the dependent’s support. Gross income is measured before

Dole Archives: s-leg\_554 002\_022\_d.pdf Page 4 of 15

CRS-2

allowing for expenses of earning income or other items deductible for income tax purposes. For example, an individual with rental property collecting $2,100 in rent with $1,000 in rental expenses could not be claimed as a dependent, since his or her gross income exceeds the personal/dependency exemption amount even though his or her adjusted gross income is only $1,100.

Support test - the taxpayer must furnish more than one-half of the support of that person for the taxable year. Excludable income not counted in the gross income test (such as social security and railroad retirement) is counted in determining whether the taxpayer has furnished over half of the dependent’s support.

Member of household or relationship — a person need not be related to the taxpayer to qualify as a dependent if he or she is a member of the taxpayer’s household and lives with him or her for the entire year. Certain dependent relatives need not live with the taxpayer or be a member of the taxpayer’s household to be claimed as an exemption. Parents and grandparents, for example, may be claimed as dependents even though they live in separate domiciles.

Citizenship test - a dependent must be a citizen or national of the United States or a resident of the United States or a resident of Canada, Mexico, the Panama Canal Zone, or the Republic of Panama for some part of the year to be claimed as an exemption by the taxpayer.

Joint return test —- a taxpayer is not allowed an exemption for a dependent if the dependent files a joint tax return.

HEAD OF HOUSEHOLD FILING STATUS

Current law provides single taxpayers with a qualifying dependent an additional benefit. A single taxpayer with a dependent not only receives the dependency exemption but also moves from single taxpayer status and tax rates to "head of household" taxpayer status and rates. Head of household rates are approximately in the middle between the higher rates of singles and the lower rates of married taxpayers filing jointly. Also, the standard deduction for head of household is higher than for singles but lower than for joint returns. There is no reduction in rates or increase in the standard deduction amount for married taxpayers who can claim a dependent.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 5 of 15

CRS-3

ADDITIONAL STANDARD DEDUCTION FOR THE ELDERLY OR BLIND

In addition to the personal/dependency exemption and the standard deduction, a taxpayer is allowed an additional standard deduction(1) if he/she is elderly or blind on the last day of the taxable year. This additional amount is $600 for an elderly or blind married individual or surviving spouse and $750 for an elderly or blind unmarried individual. After the 1988 tax year, these additional amounts are subject to adjustment for inflation. The increase, if not a multiple of $50, is rounded down to the next lowest multiple of $50. Since inflation has been relatively low, a $50 multiple has not yet been reached. Thus, the amounts of the additional standard deduction for tax year 1989 are the same as they were when enacted into law.

For purposes of claiming this additional standard deduction, the taxpayer is considered blind if the central visual acuity does not exceed 20/200 in the better eye with corrective lenses, or the widest diameter of the visual field is not greater than 20 degrees. The additional standard deduction for blindness may not be claimed for a dependent other than the spouse. An additional standard deduction for other forms of handicap is currently not allowed by Federal tax laws.

MEDICAL DEDUCTION

Under present law, only those unreimbursed medical expenses in excess of 7.5 percent of the adjusted gross income of the taxpayer may be deducted.(2) A taxpayer may include amounts paid on behalf of a person who qualifies as a dependent. Additionally, he may include expenses on behalf of a person who would qualify as a dependent except for exceeding the limit for the gross income test or except for filing a joint return with his or her spouse. Qualified medical expenses counted towards this 7.5 percent limitation include health insurance premiums, unreimbursed medical expenditures, and prescription drugs. The only nonprescription drug eligible for inclusion is insulin.

The determination of what constitutes medical care for purposes of the medical expense deduction is of special importance to the handicapped. Three special categories are enumerated below.

Footnotes:

1 Prior law provided an extra personal exemption for blindness. The Tax Reform Act of 1986 provided an additional standard deduction in lieu of this personal exemption.

2 Note that reimbursed expenses are not deductible (see page 9).

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 6 of 15

CRS-4

RESIDENCE IN A SANITARIUM OR NURSING HOME

If an individual is in a sanitarium or nursing home because of physical or mental disability, and the availability of medical care is a principal reason for his being there, the entire cost of maintenance (including meals and lodging) may be included in medical expenses for purposes of the medical expense deduction. The Tax Court found in W. B. Counts and Mildred P. Counts, Petitioners, v. Commissioner of Internal Revenue, Respondent that:

In summary, the present regulations provide that the cost of inpatient hospital care, including the costs of meals and lodging at the hospital, is an expenditure for medical care as that term is defined in section 213(e)(1)(A). It is recognized that such costs of maintenance at an institution other than a hospital may constitute expenses for medical care; that whether such costs incurred at an institution other than a hospital are deductible as medical expenses is a factual question the answer to which depends not upon the nature of the institution but upon the condition of the person and the care which he receives; that the cost of nursing attention is an expense for medical care; that if a — and we note that the regulations do not require the - principal reason for the person’s presence in an institution is the availability of medical care for him, then the costs of meals and lodging, furnished as a necessary incident to such care, for as long as the person requires the care, are deductible; and that, if the availability of medical care is not a principal reason for the person’s presence at the institution, the costs of meals and lodging are not deemed expenses for medical care, although, even in this event, the expenses for nursing attention are considered costs of medical care and are deductible. An example in subdivision (v) (b) of the regulations deals with the case of a person who resides at a home for the aged because of personal or family considerations and not because he requires medical or nursing attention; in this event, it is provided that the person’s costs of meals and lodging are not embraced within the term "medical care" but that his costs of nursing attention are deductible.(3)

SPECIAL SCHOOLING FOR HANDICAPPED DEPENDENTS

Payments for sending a mentally or physically handicapped dependent to a special school may be deducted as medical expenses if the principal reason for his attendance is the institution’s special resources for alleviating his handicap. The cost of meals and lodging supplied by such a special school, and the cost of ordinary education furnished which is incidental to the special services furnished by the school may also be included as medical expenses. Deducting

3 W. B. Counts, 42 TC 755, 763-764 (July 23, 1964).

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 7 of 15

CRS-5

the cost of attending a school for the mentally retarded as a medical expense is expressly allowable under I.R.S. Regulation 1.213-1(e)(1)(v)(a).

CAPITAL EXPENDITURES

Capital expenditures incurred by a physically handicapped individual for structural changes to his personal residence (made to accommodate the handicapping condition) are fully deductible as a medical expense. The General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee on Taxation states that examples of qualifying expenditures are construction of entrance and exit ramps, enlarging doorways or hallways to accommodate wheelchairs, installment of railings and support bars, the modification of kitchen cabinets and bathroom fixtures, and the adjustments of electric switches or outlets.

$125,000 EXCLUSION OF GAIN FROM SALE OF RESIDENCE

Under present law, gain from the sale of a taxpayer's principal residence is taxable, but the tax may be deferred. If another residence is purchased or built within the prescribed time period, the taxpayer may qualify for the nonrecognition of all or part of the gain on the sale of the old residence, thus deferring tax on the nonrecognized gain. However, the basis of the new residence is reduced by the amount of the nonrecognized gain.(4) This provision is available to all taxpayers regardless of age or handicapping condition.

A taxpayer may also elect to exclude from gross income up to a $125,000 gain from the sale of a residence, provided (1) the taxpayer was at least 55 years of age before the date of the sale or exchange, and (2) he owned and occupied the property as his principal residence for a period totalling at least three years within the five year period ending on the date of the sale. Short periods of absence, such as for vacations, even if rented during those periods, are counted towards the three-year required period. Taxpayers meeting these two requirements can elect to exclude from gross income the entire capital gain from the sale or exchange if the capital gain is less than $125,000 or the first $125,000 profit if the gain is greater. The election may be made only once in a lifetime. If either spouse has previously made an election (individually, jointly, or from a previous marriage), then neither is eligible to elect the exclusion.

A special exception to the occupancy rule is provided in the Technical and Miscellaneous Revenue Act of 1988. Added was a provision "that a taxpayer is treated as meeting the required use rule (three out of the five years preceding sale of the residence) if during the five year period the taxpayer becomes physically or mentally incapable of self care and (1) owns and uses the residence for at least one year and (2) then during any time within such

Footnote:

4 An explanation of nonrecognition of gain can be found in Internal Revenue Code Section 1034(a).

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 8 of 15

CRS-6

5-year period the taxpayer owns the property and resides in a facility (including a nursing home) licensed by a State or political subdivision to care for individuals who have become mentally or physically incapable of self-care."(5)

DEPENDENT CARE CREDIT

The child and dependent care tax credit is available to taxpayers for employment-related expenses incurred to care for a dependent or spouse who is physically or mentally disabled. Employment-related expenses include expenses for household services, day care centers, and other similar types of noninstitutional care which are incurred in order to permit the taxpayer to be gainfully employed. With the passage of the Economic Recovery Tax Act of 1981, the tax credit for dependent care was increased and liberalized. Under current law, taxpayers may claim a nonrefundable credit of 30 percent of qualified expenses if their adjusted gross income is $10,000 or less. For taxpayers with incomes above $10,000, the credit is reduced by 1 percent for each additional $2,000 of adjusted gross income until an adjusted gross income of $28,000 is reached. Taxpayers with adjusted gross incomes in excess of $28,000 are provided a minimum 20 percent credit towards qualifying expenditures. The maximum amount of qualifying expenses is $2,400 for one dependent or $4,800 for two or more dependents.(6) Table 1 which follows on the next page gives the tax credit percentage and maximum allowable credits by adjusted gross income class.

Prior to the passage of the Economic Recovery Tax Act of 1981, these expenses, in the case of elderly dependents, were eligible only if incurred for services performed in the taxpayer’s household. Under the new liberalized provision, if the dependent spends at least eight hours a day in the taxpayer’s home, expenditures made for out of home, noninstitutional care are eligible for the credit. Dependent care centers must be in compliance with all State and local regulations for the taxpayer to count such expenditures toward qualified expenses. Married couples must file a joint return in order to be eligible for the credit.

Footnotes:

5 U.S. Congress. House. Conference Committees, 1988. Technical and Miscellaneous Revenue Act of 1988; Conference Report to accompany H.R. 4333. Washington, U.S. Govt. Print. Off., 1988. p. 144. (100th Congress, 2d session. House Report No. 100-1104.)

6 Before 1981, taxpayers could claim an annual credit of 20 percent of qualified expenses up to $2,000 (for a maximum credit of $400) for one qualifying individual and $4,000 (for a maximum credit of $800) for two or more qualifying individuals.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 9 of 15

CRS-7

TABLE 1. Dependent Care Tax Credit

Maximum Credit

|  |  |  |  |
| --- | --- | --- | --- |
| Adjusted Gross Income | Applicable Percentage of Qualified Expenses | One Qualifying Individual | Two or More Qualifying Individuals |
| Up to $10,000 | 30% | $720 | $1,440 |
| 10,001 – 12,000 | 29 | 696 | 1,392 |
| 12,001 – 14,000 | 28 | 672 | 1,344 |
| 14,001 – 16,000 | 27 | 648 | 1,296 |
| 16,001 – 18,000 | 26 | 624 | 1,248 |
| 18,001 – 20,000 | 25 | 600 | 1,200 |
| 20,001 – 22,000 | 24 | 576 | 1,152 |
| 22,001 – 24,000 | 23 | 552 | 1,104 |
| 24,001 – 26,000 | 22 | 528 | 1,056 |
| 26,001 – 28,000 | 21 | 504 | 1,008 |
| 28,001 and over | 20 | 480 | 960 |

Source: Economic Recovery Tax Act of 1981 — Law and Explanation. Chicago, Commerce Clearing House. 1981. p. 30.

TAX TREATMENT OF DISABILITY BENEFITS

SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Social Security and Tier 1 Railroad Retirement Benefits received for disability are taxable only to high-income recipients. Disability benefits are taxed in the same manner as retirement benefits. The tax is computed on the lesser of one-half of the benefit or one-half of the taxpayer’s "combined income" in excess of $25,000 for single taxpayers (including heads-of-households) and $32,000 for married couples filing jointly. Combined income is defined as gross income, interest on tax-exempt obligations, and the social security or railroad retirement benefit.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 10 of 15

CRS-8

WORKER’S COMPENSATION

Worker’s compensation received by an employee because of job-related sickness or injury is fully exempt from income tax. If the employee turns over his/her compensation to his/her employer, and the employer continues to pay all or part of the employee’s regular salary, the excess of the salary payments over the amount of worker’s compensation is taxable income to the employee.

FEDERAL EMPLOYEES’ COMPENSATION

Benefits provided for disability or death resulting from an injury sustained in the performance of duty by civilian personnel in the service of the United States are exempt from income tax.

DISABILITY COMPENSATION OF CIVIL SERVANTS

Disability income received by a civil servant under a Federal, State, or local governmental plan may be partially or totally excludable from taxation if such income is in the nature of worker compensation act benefits. Such income, to qualify for exclusion from taxation, should be from a disability incurred as a result of employment and from which the employee is incapacitated--such that the employee is no longer able to perform official duties. The disability, either mental or physical, may be either temporary or permanent. Pensions and annuities are not covered under this provision and only those amounts which would have been provided under applicable workmen’s compensation acts are excludable from taxation. Thus, income receipts which exceed worker compensation benefits are taxable to the recipient.

DAMAGES RECEIVED FOR INJURY OR ILLNESS

The amount of any damages received, whether by suit or agreement, for injury or illness (but not compensation for lost wages) is exempt from tax.

ACCIDENT OR HEALTH INSURANCE BENEFITS

Disability payments, reimbursed medical expenses, and other benefits received under an accident or health insurance policy attributable to premiums paid by the taxpayer are exempt from tax. Benefits other than reimbursement for medical expenses, however, are generally taxable if they are attributable to contributions by the employer or were paid by the employer.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 11 of 15

CRS-9

REIMBURSEMENT FOR MEDICAL CARE EXPENSES

Amounts paid by an employer-financed accident and health plan to an employee as reimbursement for medical expenses are generally exempt from tax. However, such reimbursement may serve to reduce the medical expenses deduction because only those expenses that are not reimbursed are allowable as deductions.

COMPENSATION FOR PERMANENT LOSS OR DISFIGUREMENT

Compensation received for permanent loss, loss of use of a member or function of the body, or permanent disfigurement, is exempt from tax even if received from an employer-financed accident and health plan.

VETERANS’ BENEFITS

Disability compensation and pension payments received by veterans for service-connected and non-service-connected disabilities are excludable from gross income. Grants to disabled veterans for homes designed for "wheelchair living," and for motor vehicles for veterans who have lost their sight or the use of their limbs, are also not taxable.

DISABILITY RETIREMENT

Credit for the Elderly and the Permanently and Totally Disabled

For persons under age 65, the credit is only available to those who are retired on disability. The individual must be permanently and totally disabled, which is defined as being unable to engage in any substantial gainful activity because of physical or mental impairment which can be expected to result in death or to last for a continuous period greater than one year.

The 15 percent credit is computed on the lower of the amount of disability income or "initial amount.” The initial amount is determined by filing status.

Those amounts are as follows:

Single individual $5,000

Married individuals, joint return, one spouse is a qualified individual $5,000

Married individuals, joint return, both spouses are qualified individuals $7,500

Married individual, separate return $3,750.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 12 of 15

CRS-10

This initial amount is reduced by any tax-free benefit received under the Social Security Act (Title II), the Railroad Retirement Act of 1974, or a Veterans Administration program. Other amounts excludable under non-IRS Code provision further reduce the initial amount.

Finally, the initial amount is reduced by one-half the amount of adjusted gross income over the following levels:

Single taxpayer $7,500

Married taxpayer, combined AGI on joint return $10,000

Married individual filing separately $5,000.

Thus, this credit is targeted to low- and moderate-income taxpayers. As an example, a single individual will receive no benefit if income exceeds $17,500. A married couple, where both spouses are qualified for the credit and file a joint return, will lose all benefit from the credit when their combined income exceeds $25,000.

Special rules apply in some cases where both taxpayers are eligible for this credit.

MILITARY DISABILITY BENEFITS

Prior to enactment of the Tax Reform Act of 1976 amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, as well as similar amounts received by disabled members of the National Oceanic and Atmospheric Administration, the Public Health Service, or the Foreign Service were excluded from income.(7) The Tax Reform Act of 1976 eliminated this exclusion prospectively for persons who join these Government services after September 24, 1975, with specific exceptions. Disability payments administered by the Veterans Administration are excluded from income. In addition, a person who joins the military service after September 24, 1975, and retires on disability and does not receive disability benefits from the Veterans Administration, is

Footnote:

7 A member of the armed forces who met certain disability and length of service requirements could elect to draw disability retirement pay based on a percentage of disability formula or a length of service formula. Disability retirement pay based on the percentage of disability formula was totally excluded from income. Under the length of service formula, the portion of disability retirement pay equal to the amount that would have been paid under the percentage of disability formula was excluded, and the excess was subjected to the sick pay rules which existed prior to their repeal by the Tax Reform Act of 1976.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 13 of 15

CRS-11

allowed to exclude from income an amount equal to the benefits he/she would be entitled to receive from the Veterans Administration.

Otherwise, members of the armed forces who joined after September 24, 1975, are allowed to exclude military disability payments only if the payments are directly attributable to combat-related injuries. The term "combat-related injury" means personal injury or sickness which is incurred (1) as a direct result of armed conflict, (2) while engaged in extra-hazardous service, (3) under conditions simulating war, or which is (4) caused by instrumentality of war.

TERRORIST ATTACK AFFECTING CIVILIAN EMPLOYEES

A civilian employee of the United States, injured as a result of a violent attack which the Secretary of State determines to be a terrorist act, while out of the country in performance of his official duties, may exclude from his gross income amounts received as disability payments attributable to those injuries.

EMPLOYEE BUSINESS EXPENSES

A provision enacted as part of the Tax Reform Act of 1986 provides that employee business expenses must now be itemized along with other miscellaneous deductions and they are subject to a floor of 2 percent of adjusted gross income. However, a special exception from the 2 percent floor is provided for impairment-related work expenses of handicapped employees. The Internal Revenue Code of 1986 provides that these expenses are "for attendant care services at the individual’s place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work and with respect to which a deduction is allowable under section 162." Section 162 of the Code is for trade and business expenses.

REMOVAL OF ARCHITECTURAL AND TRANSPORTATIONAL BARRIERS

The removal of architectural and transportation barriers can be treated as a deductible expense (rather than as an expenditure which is capitalized over the useful life of the asset). Expenditures must be made to make facilities or public transportation vehicles (either owned or leased by the taxpayer and used in the taxpayer’s trade or business) more accessible to and usable by the elderly and handicapped. There is no requirement that such expenditures be made only for the benefit of employees but rather the provision applies equally to all elderly and handicapped persons.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 14 of 15

CRS-12

The maximum deduction permitted a business taxpayer (either individual, corporation, or a controlled group of corporations) for qualifying expenditures is limited to $35,000 a year. When first adopted, the qualifying expenditures were limited to $25,000 a year. The deduction has been made a permanent part of the Internal Revenue Code by the Tax Reform Act of 1986.

TARGETED JOBS TAX CREDIT

A targeted jobs tax credit for handicapped individuals undergoing vocational training is available to employers. The credit is equal to 40 percent of the first $6,000 of wages paid during the first year of employment. Thus, the maximum amount of the credit per employee is $2,400. The amount of the credit reduces the company’s deduction for wages. It is required that the employee be employed for a minimum of 90 days or must complete 120 hours of service for the employer to receive the credit.

The credit was extended through September 30, 1990, in the Omnibus Reconciliation Act of 1989.

Dole Archives: s-leg\_554\_002\_022\_d.pdf Page 15 of 15